CONDUCT OF MONETARY POLICY
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CONDUCT OF MONETARY POLICY

WEDNESDAY, FEBRUARY 19, 1986

House of Representatives,
Committee on Banking, Finance and Urban Affairs,
Washington, DC.

The committee met at 10 a.m., pursuant to notice, in room 2128, Rayburn House Office Building, Hon. Fernand J. St Germain (chairman of the committee) presiding.

Present: Chairman St Germain; Representatives Gonzalez, Neal, Hubbard, LaFalce, Oakar, Vento, Barnard, Schumer, Roemer, Lehman, Morrison, Cooper, Erdreich, Levin, Carper, Torres, Kleczka, Gordon, Manton, Wylie, McKinney, Leach, Parris, Wortley, Roukema, Hiler, Ridge, Chandler, McCandless, Kolbe, and McMillan.

The **Chairman**. The committee will come to order.

To avoid the possibility of anyone profiting from inside information and to assure fair and equal treatment for the news media, this committee has made every effort to avoid premature release of the monetary policy report.

Copies were distributed to the members of the committee last night with a request from me that every step possible be taken to assure confidentiality of the material until this hearing opened this morning.

The copies of the testimony were also marked by the Federal Reserve with an embargo for 10 a.m. this morning. It is the type of embargo that is normally respected by the news media.

Despite these efforts, significant details of the monetary report and excerpts from the testimony were carried in today's editions of the Wall Street Journal. The Wall Street Journal obviously feels it is beatified and therefore need not observe embargos.

I truly regret that material of this type—which is clearly market-sensitive—cannot be released in a more orderly manner—in a manner that protects the public interest and provides fair treatment for all of the media.

Chairman Volcker, we want to welcome you here this morning.

For years, the Federal Reserve has been pursued by a group of "monetarists" who fervently believe that the Nation's money supply should be kept within narrow rigid bands. Chairman Volcker and his adherents have successfully resisted this theory as far too inflexible and unimaginative to meet the needs of a dynamic economy.

Ironically, though these conservatives failed to gain a toehold on monetary policy, they have succeeded on fiscal policy. It is now fiscal policy that is placed on automatic pilot.

Paul Volcker remains the only free man in the Federal Government's economic policymaking machinery. Everyone else is stuck with the preset rigidities of Gramm-Rudman.

This freedom may appear to be a blessing, but it places a heavy burden of responsibility on the Federal Reserve. In past years, when the Congress pressed the Federal Reserve to help various sectors of the economy through monetary policy, we have been told that such help, if needed, should emanate from congressional appropriations and not from the Federal Reserve.

Congress, thanks to Gramm-Rudman, no longer has the flexibility to respond to many of the Nation's most basic economic and social needs. So, some may look again at the vast powers of the Federal Reserve and see possibilities for averting economic and social disasters that have been preordained by Gramm-Rudman.

Through 25 years on this committee, I am well versed on the Federal Reserve's cliches about credit allocation and the emotion that it evokes down on Constitution Avenue. But, Gramm-Rudman is bringing us many unexpected and undesirable consequences as well as strange byproducts. The Federal Reserve should not expect to be immune while other institutions are wrung out and turned upside down.

This is the season when Washington's economic policymakers hide behind the mammoth national aggregates, comfortably assured that Grandma Jones will never break the code with her little pocket calculator. Described in aggregate terms, the fight against inflation, big deficits, and big spending become equated with the flag, motherhood, and apple pie. But, the people do not live by aggregates alone.

While I know the remarks were lost in the welter of budget numbers and Gramm-Rudman projections, I sincerely hope that the Governors of the Federal Reserve, the Office of Management and Budget and the President—and Don Regan—have an opportunity to reflect on the statements of Archbishop Rembert G. Weakland of Milwaukee at the recent symposium on the 40th anniversary of the Joint Economic Committee.

The good archbishop serves as chairman of the Committee on Catholic Social Teaching and the U.S. Economy of the National Conference of Catholic Bishops, and here are his sharp reminders of what so often is forgotten by Washington's economic experts:

> * * * Behind the maze of statistics and the rise and fall of economic indicators lie human lives and individual tragedies and successes. Behind the charts are real neighborhoods and cities and families deeply affected by the social consequences of economic decisionmaking. It is precisely because these economic decisions ultimately affect human persons that economic issues must also be seen as moral issues—issues that cannot be adequately resolved without considering the human and moral values that are inherently part of them. Therefore, the formulation and implementation of economic policies cannot be left solely to technicians, special interest groups and market forces. It must also involve a discussion of the ethical values and the moral priorities of our Nation.* * *

The Federal Reserve, by its policies and its vast influence in the arena of public opinion, has much to do with whether there is a baseline of human values when economic policy is calculated.

Independence is a cherished word at the Federal Reserve and every chairman has spent much time and energy to preserve it for the agency. Its definition has been often vague, but if it is to mean anything, it requires the Federal Reserve to speak out in clear terms when it sees economic policy headed in the wrong direction. Much of the Nation, for good or bad, hangs on the words of the Federal Reserve Chairman. Most of the economic columnists repeat his words over and over in terms of high reverence.

Silence, or policy disagreements spoken only in economic doubletalk, neither enhances the Federal Reserve's independence nor the public's understanding of critical economic problems.

To paraphrase Dante, "The hottest place in Hell is reserved for those who remain neutral in a time of crisis."

Chairman Volcker, we sincerely hope that the hours you spend here today result in a frank and open discussion of economic policy. You have seen the President's budget. You have heard the explanations and those of his closest advisers. Do you think it is a realistic budget based on realistic calculations and projections?

You have heard the President say time and again, "No tax increase." In the view of the Federal Reserve, is this a realistic policy under current economic conditions?

So that we can begin this discussion today on solid ground, I would like for you now, Chairman Volcker, prior to your prepared remarks, to address these two questions: First, do you regard the basic economic assumptions of the President's budget to be realistic and, second, do you advocate a tax increase?

Chairman Volcker.

Mr. **Volcker**. Mr. Chairman, I appreciate those remarks. I feel I am up here to testify on monetary policy rather than fiscal policy and we're getting a little off course perhaps at the start.

Whether that budget is realistic or not in terms of its possible enactment obviously depends upon you gentlemen and whether you think it's realistic or not and whether you are prepared to vote for the spending cuts that the President has proposed; and that is a matter of decision for you.

I have long said that it is a matter of great priority to get the budget deficit reduced. If you can't do it on the spending side, which is where I think, from an economic standpoint the priority should lie, at that point you begin looking at the possibility of tax increases. But the first question is, in fact, whether Congress can enact the kind of spending decreases, whether they are precisely the ones the President proposed or otherwise, to see whether that budget is realistic.

The **Chairman**. Chairman Volcker, I assume that you have analyzed his budget requests and his projections. You must certainly have an opinion as to whether or not they are realistic.

Mr. **Volcker**. Well I have not analyzed the spending programs in any detail. I have looked at the economic assumptions that underlie them and, as I would have indicated anyway, the Federal Reserve members collectively, the members of the Open Market Committee collectively have a somewhat lower central tendency for economic growth this year than is in the budget assumptions, although some members of the committee did project economic growth of 4 percent or higher this year, so the difference was not very large.

We actually have—again speaking of central tendencies and most members of the committee projected—assumed a somewhat lower inflation figure. I don't think those differences in themselves are enough to have changed the budget outcome drastically. There is nothing in the assumptions or the differences in assumptions I would see it for this year that would bear in a really large way on the budgetary outcome. I'm just speaking of 1986.

The **Chairman**. Right. Now that being the case, is it proper to assure that your conclusion is that due to the fact that these assumptions are not that far off from those which you and the Fed have come up with, that you therefore don't feel that there will be any need for a tax increase?

Mr. **Volcker**. That depends upon whether or not you follow through on the spending side. He has proposed very large cuts in spending, but that has nothing to do with economic assumptions. There are very large cuts in spending proposed and there is I know a lot of argumentation among budgetary experts and administration and congressional experts about what is implied by current programs in the Defense Department, for instance. I have not got any independent judgment on those matters.

I do know that it takes a very large effort on the spending side if that budget is going to become a reality in any way like the projected net outcome, given the economic assumptions that are made.

The **Chairman**. If there are shortfalls on the spending side, then what is the alternative?

Mr. **Volcker**. The alternative is obviously to look at the revenue side, depending upon how big those shortfalls are, but that's not——

The **Chairman**. But as of now, you don't feel that there will be any need for a tax increase?

Mr. **Volcker**. Not if you carry through on those spending programs.

The **Chairman**. Thank you.

Mr. Wylie.

Mr. **Wylie**. Thank you very much, Mr. Chairman, and I join you in welcoming Chairman Volcker here this morning and certainly look forward to his testimony.

May I say that he does touch on some of the issues that you asked about in his testimony and they are timely questions, of course.

I think it is particularly appropriate that you are here this morning, Chairman Volcker, given the publicity that you received in Newsweek magazine this week. I want to congratulate you for that and I know that your testimony will be received very well indeed, and I wouldn't disagree with their appellation that you may be the second most powerful man in America. I'm glad you're here.

The subject of your testimony will be of more than usual interest because of that and also because we need to know from your perspective is the economy lagging? As some economists say, did it lag during the last quarter and will it be picking up during the remainder of the year? That will of course be factored into the questions which the chairman just asked you a little earlier.

Some conclusions as to the conduct of monetary policy; will it change given the schedule of the decline in Federal spending? The Wall Street Journal article here, which the chairman alluded to, says that there will be no change in monetary policy, and how will the implementation of Gramm-Rudman affect your job?

Another important area which you touch on briefly is the area of international finance: interest rates, and the value of the dollar have declined further. We have, however, not as yet seen the beneficial effects of these declines on our export business, including agriculture and on our foreign accounts. I am sure you will address that to see if the developments will be more optimistic or can be more optimistic in the future.

In any event, Mr. Chairman, I look forward to your prepared testimony and the subsequent exchange which I know will be most fascinating.

Thank you, Mr. Chairman.

The CHAIRMAN. We are now looking forward to fascination. [Laughter.]

We will put your entire statement in the record, Chairman Volcker, and you may proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Fascinating or not, I think my statement does touch upon many of the questions that you both have raised and I will proceed to read it.

I am pleased to appear before the committee once again. As you know, 1986 has begun with the economy continuing to move forward after more than 3 years of expansion.

Looking ahead there are some highly encouraging signs. The larger employment increases in recent months are reflected in relatively confident attitudes by consumers. Manufacturing output as a whole, which had been sluggish during much of 1985, is again rising even though many areas continue to face strong competition from abroad. Lower interest rates and higher stock prices—buoyed in part by the action of the Congress in improving prospects for declining Federal deficits in the years ahead—have made it less expensive to finance new business investment and housing. With few exceptions, excessive inventories, often in the past a harbinger of economic adjustments, appear absent.

While productivity growth has been rather disappointing, wage restraint in much of industry and lower commodity prices have kept costs under control. The sharp break in oil prices should be an important force, cutting costs and prices in the period immediately ahead, in the process, releasing real purchasing power to U.S. consumers. Moreover, changes in exchange rates and the welcome initiatives taken by the Congress and the administration toward budgetary restraint, offer the potential for dealing with two of the major and interrelated imbalances in the economy that I have spoken about with you so often—the enormous fiscal and trade deficits.

Altogether, the opportunity clearly remains for combining sustained expansion with greater price stability in the period ahead, building on the progress of the past 3 years. In my judgment, the present expansion—already longer than the postwar average for peacetime years—is not about to die from old age or sheer exhaustion. We don't have the pressures on capacity, the excess inventories, the accelerating costs and prices, or the rising interest rates that are typically presaged cyclical downturns in the past.

Yet, any claim that we live in an economy in which every prospect pleases would be idle pretense. There are evident points of economic pressure and financial strain, some of them aggravated by the sharp decline in oil prices itself. While the adverse trends are being changed, the deficits in our budget and trade accounts will literally take years to correct. And, we have long since passed the time when we could, with any validity, insulate ourselves from the difficulties of neighbors and trading partners to which we are bound by strong ties of finance and trade.

Most of these threats, in magnitude and in combination, are unique, certainly in our postwar experience. They demand our full attention if we are to deal with them successfully.

Take, for instance, the trade problem. The dollar had risen to extraordinarily high levels by early 1985, with the effect of undercutting our trade position vis-a-vis major industrial competitors. At the same time, the relatively rapid growth in demand for goods and services in the United States, at a time of sluggish growth abroad, attracted a large volume of imports. The net result was to drive our trade deficit to a rate of close to $150 billion by the end of last year and to about $125 billion for the year as a whole.

No doubt, given the extreme values the dollar had attained internationally in 1984 and early 1985, an adjustment in exchange rates has been a necessary part of achieving a better competitive equilibrium and of responding to destructive protectionist pressures. That was explicitly recognized in the meeting of the finance ministers and central bankers of the five leading industrialized countries in September. By now, a substantial adjustment in exchange rates has been made, placing our producers in a stronger competitive position.

But we also know, from hard experience here and abroad, that changes in actual trade flows necessarily lag changes in exchange rates by a period extending into years, that currency adjustments can assume a momentum of their own, and that sharp depreciation in the external value of a currency carries pervasive inflationary threats.

No doubt, some depreciation in the dollar, after the rapid run up, could be absorbed without a sharp or immediate impact on domestic prices. But we cannot afford to be complacent. Inevitably, prospects for balance in our internal capital markets—and therefore, prospects for interest rates—remain for the time being heavily dependent on the willingness of foreigners to place huge amounts of funds in dollars and on the incentives for Americans to employ their money at home. In essence, the financing of both our current account deficit and our internal capital needs—so long as the Government deficit remains so high—is dependent on a historically high-net capital inflow. Clearly, the orderly balancing of our demands for funds with supply in those circumstances requires continuing confidence in our currency.

I recognize and appreciate the importance of the efforts that the Congress and the administration have made to place the budget deficit on a declining trend. I know that effort will continue to require the hardest kind of choices. But we can also see some of the potential benefits in improved market sentiment. The net result should be both to reduce the risks of inflation and to make us less dependent on foreign financing in the years ahead.

At the same time, oil imports apart, improvement in our trade balance for the next year or longer is in large part dependent not on depreciation of our currency but on greater growth by our trading partners. More competitive pricing is of limited value when foreign markets are not growing strongly, and when producers abroad do not themselves have expanding, profitable markets at home.

Prospects in that respect remain quite mixed. There have been signs of somewhat stronger growth in Germany and elsewhere in continental Europe. However, it remains questionable whether that growth will in fact be strong enough to reduce appreciably continued high levels of unemployment, now averaging more than 10 percent for the continent as a whole. In Japan, where unemployment is historically at much lower levels, growth by those same historical standards is sluggish, with the appreciation of the yen itself a restraining factor.

As appropriately emphasized at the September G-5 meeting, a better world equilibrium, including more rapid improvement in our trade balance, is clearly dependent on structural and other measures to deal with the sources of imbalances. The Gramm-Rudman-Hollings legislation represents one important approach to that end. Stronger growth patterns in other leading countries are also directly relevant. The opportunities for policies to work toward that result this year appear to be greatly enhanced by the strongly beneficial effects of the declines in oil prices and the appreciation of their currencies. Both developments reinforce the already strong prospects for price stability in those countries.

Should oil prices remain close to present levels, that development will also be a powerful force offsetting, and in the short run probably more than offsetting, the direct and indirect effects of the lower international value of the dollar on our overall price performance. At the same time, the effect is to release real purchasing power and cash flow to American consumers and oil-consuming businesses. The potential addition to real consumer income should work in the direction of offsetting the effects on purchasing power that some have foreseen in the full implementation of the deficit reduction program called for by the Gramm-Rudman-Hollings legislation over the course of this year.

With similarly beneficial effects for other consuming countries, that is part of the basis for a sense of growing optimism about world economic prospects. But, of course, the effects are sharply adverse for energy producers, affecting important regions in the United States where energy production and exploration loom so large, and therefore prospects for investment as a whole. The added strains for certain already heavily indebted developing countries are even more acute. Moreover, the pervasive pressures on much of the agricultural sector in this country remain, although recent legislation by the Congress addressed and should help stem further deterioration.

These sectoral strains and imbalances point up the crucial importance of maintaining the essential safety and soundness of our financial system, and in particular our depository institutions. For a long time, that was something we in this country thought we could take for granted. And it was partly that feeling, combined with accelerating inflation and other factors, that contributed to much more aggressive lending behavior over the years—lending that has now led to unanticipated problems in a period of disinflation and greater competitive pressures. Today, measures to protect the basic financial fabric necessarily assume a high priority, and that effort will require appropriate action by the Congress as well as the regulatory authorities.

Finally, in surveying the economic setting for monetary policy, I must call your attention to the disappointing record with respect to productivity over recent years viewed generally, at least as recorded by the standard national statistics. Developments in that respect during 1985, when productivity for nonfarm businesses as a whole showed no growth, are hard to explain. In manufacturing, where recorded performance is substantially better than in other sectors, the slower productivity growth may be a reflection of the leveling of output. But other sectors were growing relatively fast, without reflection in productivity improvement.

Perhaps part of the seeming problem lies in the inherent difficulty in measuring the volume and quality of output in the dominant service sector of the economy. But the results do raise further questions about the growth potential of the economy as recorded by the GNP statistics—how fast we can expect the GNP to grow in a sustained way without excessive pressures on human or physical capacity. Over the past 6 months, for instance, the unemployment rate has dropped by a full one-half of 1 percentage point—desirable in itself but accompanied by a recorded annual rate of output growth of only 2¾ percent.

In the end, it is largely productivity that governs prospects for per capita income growth; together with growth in the number of workers, it sets a limit on our total economic growth. Fortunately, in developing monetary policies now, we do not need to reach precise judgments about our long-term growth potential; today, capacity utilization is still somewhat below, and unemployment somewhat above, average levels for periods of business prosperity. Recent productivity trends, nonetheless, do introduce an unwelcome cautionary note about the longer run.

Any description of the opportunities and risks in the current economic situation points up the fact that the formulation and implementation of monetary policy need to take account of a variety of sometimes conflicting objectives and criteria. In the current setting, other policy approaches—toward the budget, toward international finance, toward trade, and toward other areas—are obviously critical to the success of the common effort, just as the pervasive and indirect effects of monetary policy can bear upon the success of the other policies. Moreover, institutional and economic changes have strongly affected the behavior of certain policy guideposts—notably M1 and debt—relative to other economic magnitudes. Consequently, I do not believe that in present circumstances there is any escape from the need for a substantial element of judgment in the conduct of Federal Reserve policies.

That need was illustrated in 1985. Over the course of the year, monetary policy remained in a generally accommodative mode, in the sense the pressures on bank reserve positions were both limited and little changed. The discount rate was reduced once in the spring, from 8 to 7½ percent, and most market interest rates declined by 1 to 2 percentage points, generally reaching the lowest levels since mid-1979 or before.

As illustrated in certain charts attached, the broader monetary aggregates, M2 and M3, remained generally within the ranges targeted at the start of the year. At the same time, however, the narrowly defined measure of the "money supply," M1, grew persistently above the range set both at the start of the year and after the range was reset in July. That aggregate ended the year almost 12 percent above the year earlier level, a historically high rate of growth.

In technical terms, that large overshoot was permitted in the light of a persistent and sizable decline in M1 "velocity"—that is the relationship between M1 and the nominal GNP. That decline in velocity was apparent whether measured contemporaneously or with a one or two quarter lag between money and GNP. In other words, the exceptional growth in M1 seemed to be matched by an equally exceptional decline in velocity, suggesting the high M1 growth in 1985 does not imply the same inflationary potential, at least for the near term, as in the past.

Less abstractly, the judgment of the Federal Open Market Committee as the year developed was that the rather strong restrictive action that would have been necessary to maintain M1 within it's targeted range was not justified in the light of the different signals conveyed by the much more restrained growth in M2 and M3, the slower growth in overall economic activity, the margins of capacity that remained, and the continuing progress toward price stability. For much of the year, the dollar remained high, and that fact was another strong signal that monetary policy was not unduly liberal.

We were aware, of course, of some conflicting evidence. During much of 1984 and 1985, domestic demand—that is the spending of consumers, businesses, and governments—continued to expand at a rate well beyond the rate of domestic output, which is measured by the GNP. In fact, the rate of demand increase, if maintained, would probably be beyond our long-term growth potential. In that sense we continued to live beyond our means, at the expense of a widening trade deficit.

Moreover, private as well as public debt continued to accumulate at a historically high rate. Running above the 9–12 percent monitoring range set out at the start of the year. The aggregate debt statistics, portrayed in relation to GNP on a chart attached, exaggerate the problem to some degree. There has been massive issuance of tax-exempt securities in anticipation of tax law changes, for reinvestment in Treasury securities in pending subsequent refundings, and for a variety of projects requiring new capital. These activities lead to "double counting" in the aggregate statistics because both the new municipal debt and the debt acquired in employing the funds borrowed are included in the total. At the same time, substitution of debt for equity by businesses continued unabated, with about $100 billion of equity retired by a combination of stock repurchase programs, so-called leveraged buyouts, and as part of mergers and acquisitions.

The strongly rising stock market and lower interest rates had the effect of greatly increasing consumer wealth, measured by current market values, and lowering the cost of capital to business. Nonetheless, the trend of debt creation, with its implications of greater leveraging and potential financial fragility, remains disquieting, particularly in an environment of progress toward greater price stability. Indeed, as I suggested earlier, there is already ample evidence in the financial area of the consequences for individual institutions of extended financial positions and unduly loose credit standards. The crises in the thrift industry in Maryland and Ohio, where Federal insurance and supervision were absent, illustrated in extreme form the consequences of essentially speculative lending and lax market practices.

A more pointed question for the deliberations of the Open Market Committee has been the lasting significance of the sizable increase in M1. We are well aware, as I have often reported to this committee, of the long history and of the economic analysis that relate excessive money growth to inflation over time. The operational question remains as to what, in specific circumstances, is in fact excessive in the light of recent velocity behavior. That question is greatly complicated both by the changed composition of M1, which now includes accounts that receive interest close to market levels and clearly have a large savings as well as transaction-oriented component. The disinflationary process and the associated decline in market interest rates also have implications for the willingness to hold money.

Enough evidence has now accumulated since the peak inflation years to suggest two conclusions: First, that the long upward trend in velocity of 3 percent or so characteristic of most of the postwar period—when inflation and interest rates were generally trending upward—will probably not be typical of a world in which inflation and interest rates are trending downward and in which M1 has a growing savings component. Second, that M1 may be more sensitive to short-term fluctuations in interest rates.

For 1985 specifically, our work strongly indicates that much of the unexpected decline in M1 velocity was a response to the sharp reduction in interest rates late in 1984, continuing at a lesser pace over much of last year. In a context of contained inflation, a generally strong dollar, and more muted economic growth, the decline in interest rates did not appear in itself to risk excessive economic stimulation, with renewed inflationary potential. Moreover, neither of the broader monetary aggregates, which remained within their target ranges, confirmed excessive monetary expansion.

Looking ahead to 1986, the Open Market Committee decided to take account of the greater uncertainty associated with the relationship between M1 and economic activity and prices by adopting a relatively broad M1 target range of 3 to 8 percent. While wider, that range is centered on the same midpoint, 5½ percent, as the tentative 4- to 7-percent range set out last July. In fixing that range, the committee anticipated that velocity would not drop at nearly the rate of 1985. Without some reversal of the sharp drop in velocity last year, growth toward the upper end of the range could well be appropriate. More broadly, the committee agreed that changes in M1 would be evaluated in the light of the presence—or absence—confirming evidence of excessive growth in M2 and M3. For both those aggregates, the tentative growth ranges of 6 to 9 percent set in July were reaffirmed.

In establishing these target ranges, members of the Federal Reserve Board and Reserve bank presidents anticipated the economy would grow somewhat more rapidly than in 1985 and that the unemployment rate would continue to decline gradually. Views on the outlook for prices were rather mixed, with some anticipating measurable further progress toward stability, particularly in the light of the oil price decline, while others expected that the consequences of the lower exchange rate may, for a time, put stronger upward pressure on prices. While the central tendency of the projections for real growth is lower than that of the administration, so are most of the projections of prices by participants in the Open Market Committee. The differences are not so large as to suggest, in themselves, inconsistency with the monetary growth targets; indeed, several Board members and presidents anticipated real growth in the 4-percent area. I might also note the somewhat lower unemployment rate generally anticipated by the committee participants suggests more limited productivity growth than implied by the administration projections.

Monetary policy is implemented day by day and week by week by determining the appropriate degree of pressure on bank reserve positions in the light of monetary growth, judged in the context of the flow of information about the economy, the outlook for prices, and domestic and international financial markets, including the value of the dollar in the foreign exchange markets. In the latter connection, circumstances now are, of course, very different than during most of 1985. The potential inflationary implications of further depreciation of the dollar, while likely to be offset for some time by lower oil prices, need to be fully considered in the implementation of policy.

At present, with the various monetary aggregates at reasonable levels relative to their new target ranges, and taking account of the crosscurrents in other factors bearing on policy, there has been no occasion for significant change in the degree of pressure on bank reserve positions. As you know, both intermediate and long-term interest rates have been declining to the lowest levels seen in years and the stock market has been ebullient. The justification, and the sustainability, of those developments lies in a combination of prospects for budgetary restraint, the favorable impact of lower oil prices, and improved inflationary expectations and performance. The challenge for monetary policy insofar as it can contribute, is to help assure that those favorable prospects for maintaining progress toward stability can be in reality in the context of a growing economy. The implementation of policy will be conducted in the light of that broad objective.

I referred earlier to the pressures in some areas of the credit markets growing in large part out of the backwash of overly aggressive lending policies in the earlier climate of accelerating inflation. Indeed, those concerns have been aggravated in more recent years by a continued highly aggressive approach by some institutions seeking high returns, with their own liabilities effectively underwritten by Federal insurance. These problems, and appropriate responses to them, are too large a subject for me to deal with in the time available today; we have discussed them before on a number of occasions.

I do want to report that the Federal Reserve has underway a number of initiatives to help deal with the problems more effectively. They include strengthening our force of examiners and supervisory personnel so that they are equipped to meet higher standards in the frequency and intensity of examination of member banks and holding companies. Certain regulatory steps have been undertaken as well. Specifically, we have issued for public comment a proposal for a framework of adjusted capital/asset ratios designed to supplement our present capital standards. The proposed standards are designed to take account of the different characteristics of bank assets and to incorporate allowance for off-balance sheet risks that have been proliferating rapidly at major banks here and abroad in recent years. I know other regulatory agencies have comparable initiatives underway in the supervisory and regulatory area.

By its nature, this supervisory effort must be a continuing process, but it has particular relevance in this turbulent period.

Moreover, I can only emphasize to you again my longstanding concern that you act, and act soon, to modernize our basic laws governing the structure and nature of our depository system. After decades of little change in the legal structure, technological and market developments have together created a new competitive environment. That change, without a coherent legislative framework, has sown enormous confusion about the proper and legitimate role of banks, bank holding companies, thrift institutions, and their commercial and financial competitors. Regulatory decisions attempting to apply current laws, sometimes conflicting in themselves, are regularly challenged in the courts. The results are capricious as both regulatory bodies and the courts inevitably reach different conclusions in ambiguous circumstances.

The courts themselves in recent decisions have emphasized the need for fresh congressional guidance. I can only reiterate my own view that, without such a review, the banking and thrift industries are left adrift, driven to exploit perceived loopholes in present law on the one hand, while on the other hand, their basic and regulated business is undercut by commercial organizations and investment houses operating without the protections provided by the Federal safety net. The result is a clear threat not only to the coherence but also to the safety and soundness of the whole. Time is growing short.

From another perspective, the decline in oil prices has presented an enormous new challenge to a few countries that have been heavily dependent on oil resources for the development of their own economies. The problem is particularly acute with respect to Mexico, with which we have close trade and financial relationships, but is certainly not limited to that country.

In the broadest terms, the initiatives outlined by Secretary Baker some months ago for managing a second stage of the international debt crisis provide a constructive and needed overall framework for dealing with problems. He emphasized the importance of achieving a solution in the context of overall financial and economic policies conducive to sustained growth. That, in turn, requires complementary actions by the borrowing countries, by creditors, and by multilateral development institutions alike.

In essence, the borrowing countries themselves—Baker plan or not—appear to have the strongest kind of incentives to take those actions necessary to improve the efficiency and competitiveness of their own economies, including the development of their potentially vast nonoil resources. Those fundamental measures will be more effective, with faster results, to the degree those nations also have grater assurance of access to growing external markets for their products. Resistance to protectionism should, of course, be easier to achieve in a context of an expanding world economy, the prospects for which are enhanced by the same decline in oil prices that makes the pressures more acute for the oil-producing countries.

The restructuring process can be greatly assisted by cooperation with such institutions as the World Bank and Inter-American Development Bank, which have funds available for substantially larger loan programs in support of fundamental economic adjustments, and with the International Monetary Fund. On that basis, I believe necessary margins of external private investment or loans can continue prudently to be made available to meet essential external needs. Indeed, without complementary policies by international institutions and creditors, the will to find constructive outward-looking solutions to the problems by the borrowers themselves will inevitably be undermined, and the adverse implications would extend far beyond the economic arena.

For some heavily indebted countries that either import a sizable portion of their energy requirements or are essentially neutral in that respect, recent developments should ease the task. But I do not in any way want to minimize the challenge for others—for Mexico, Ecuador, Nigeria, and Venezuela. What I do suggest is that the fundamental premises of the total effort by borrowers and creditors alike in managing the debt situation remain valid. I believe that, with will and wisdom, the basis remains for working through this inevitably difficult period in a way that will ultimately reinforce prospects for longer term growth.

I conclude as I started, Mr. Chairman.

With constructive policy responses, recent developments carry the potential for enhancing prospects here and elsewhere for a sustained period of growth in a context of price stability. But, if those are to be actually achieved, we must also clearly recognize, and collectively deal with, points of strain and danger, some of them stemming from the very successes of the past.

Economic history is replete with examples of countries that, in attempting to correct overvaluation of their currencies, failed to take advantage of their improved competitive positions. Too often, they lapsed into a debilitating and self-defeating cycle of external depreciation and internal inflation, at the expense of an eroding loss of confidence, higher interest rates, and impaired growth.

It would be foolish to presume that the United States is somehow immune from that threat—we had too much adverse experience in the 1970's to indulge in wishful thinking in that respect. Instead, in our monetary and fiscal policies, we need to be realistic about the danger and be fully sensitive to the need to maintain confidence in our currency.

Fortunately, the sharp decline in energy prices now underway should, for months ahead, help assure satisfactory price performance, making the job of maintaining progress toward stability much easier. But, those lower prices are no unmitigated blessing. They create new uncertainties and stresses for some regions of the economy, for some financial sectors, and particularly for some important developing countries and trading partners. Those stresses need to be contained and dealt with in a constructive way, and we need to guard against conditions that might lead to a repetition of past energy shortages.

The sense of greater confidence about our fiscal prospects still needs to be converted into reality. Whatever the fortunes of the Gramm-Rudman-Hollings legislation in the courts, or the merits of that particular approach toward the problem, the direction and broad spirit of the effort seems to me essential if we are to correct deep-seated imbalances that, sooner or later, would only undercut our bright prospects.

The success of all our efforts is dependent in substantial part on complementary policies by other countries—their success in enhancing their growth and stability, in opening markets to us, and others, and in helping to deal with points of strain in the international financial fabric.

Most other industrialized countries have, as a matter of priority, been deeply concerned with restoring price stability and reducing fiscal deficits. Remarkable strides have been made toward those goals. However, their growth, at least until now, has been heavily dependent upon rising trade and current account surpluses. Today, there appears to be a prime opportunity for encouraging home grown expansion, larger imports, and better international balance.

For the longer run, I welcome the call by the President to consider what steps might be desirable to achieve and maintain greater exchange rate stability internationally. No one should think that task is a simple one. It cannot in any way substitute for disciplined and complementary domestic policies. Indeed, meaningful progress would imply even greater demands on those policies and on international cooperation. But surely we have had enough experience, here and elsewhere, with the distorting effects of extreme exchange-rate volatility to make that effort to reexamine the international system worthwhile. In a fundamental sense, that is a corollary of the simple observable fact that the economic fortunes of all countries—including the United States—are inextricably interlocked.

We have come too far, and the stakes are too high, to fail to rise to the evident new challenges.

We have to recognize that depreciation of our currency does not in itself provide any fundamental solution, and is in fact a two-edged sword.

The budgetary effort must be sustained.

If we expect to benefit from the break in energy prices, we must collectively respond to the points of strain.

We need to be patient when patience is required. The trade and budgetary and financial problems will be with us for some time; at the same time, we need to be insistent in carrying through the measures to deal with them constructively.

In much of this, I recognize the Federal Reserve and monetary policy have a vital role to play. Given the cross-currents in the economy and the sometimes conflicting signals among the guideposts to policy, there will be a high premium on judgment. But through it all the basic objective does not change. We are convinced that sustained growth in the United States—and much more—is dependent upon maintaining progress toward price stability over time. And given our weight in the world, that same stability must be one of the foundation stones of a prosperous and integrated global economy.

Mr. **Volcker**. Thank you, Mr. Chairman.

[The prepared statement of Mr. Volcker with the attached copy of the "Monetary Policy Report to Congress" pursant to the Full Employment and Balanced Growth Act of 1978 follow:]

For release on delivery
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Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

February 19, 1986

I am pleased once again to appear before this Committee to discuss the approach of Federal Reserve policy within the larger economic setting at home and abroad.

As you know, 1986 has begun with the economy continuing to move forward after more than three years of expansion. Today, more people are employed relative to the working age population than ever before recorded. Unemployment has continued to fall. Happily, the continuing expansion has so far been achieved while inflation remained at the lowest rate in more than a decade.

Looking ahead, there are some highly encouraging signs as well. The larger employment increases in recent months are reflected in relatively confident attitudes by consumers. Manufacturing output as a whole, which had been sluggish during much of 1985, is again rising even though many areas continue to face strong competition from abroad. Lower interest rates and higher stock prices -- buoyed in part by the action of Congress in improving prospects for declining federal deficits in the years ahead -- have made it less expensive to finance new business investment and housing. With few exceptions, excessive inventories, often in the past a harbinger of economic adjustments, appear absent.

While productivity growth has been rather disappointing, wage restraint in much of industry and lower commodity prices have kept costs under control. The sharp break in oil prices should be an important force cutting costs and prices in the period immediately ahead, in the process releasing real purchasing power to U.S. consumers. Moreover, changes in exchange rates and the welcome initiatives taken by the Congress and the Administration toward budgetary restraint offer the potential for dealing with two of the major, and interrelated, imbalances in the economy that I have spoken about with you so often -- the enormous fiscal and trade deficits.

Altogether, the opportunity clearly remains for combining sustained expansion with greater price stability in the period ahead, building on the progress of the past three years. In my judgment, the present expansion -- already longer than the postwar average for peacetime years -- is not about to die from old age or sheer exhaustion. We don't have the pressures on capacity, the excess inventories, the accelerating costs and prices, or the rising interest rates that have typically presaged cyclical downturns in the past.

Yet, any claim that we live in an economy in which every prospect pleases would be idle pretense. There are evident points of economic pressure and financial strain, some of them aggravated by the sharp decline in oil prices itself. While the adverse trends are being changed, the deficits in our budget and trade accounts will take years to correct. And, we have long since passed the time when we could, with any validity, insulate ourselves from the difficulties of neighbors and trading partners to which we are bound by strong ties of finance and trade.

Most of these threats, in magnitude and in combination, are unique, certainly in our postwar experience. They demand our full attention if we are to deal with them successfully.

Take, for instance, the trade problem. The dollar had risen to extraordinarily high levels by early 1985, with the effect of undercutting our trade position vis-a-vis major industrial competitors. At the same time, the relatively rapid growth in demand for goods and services in the United States, at a time of sluggish growth abroad, attracted a large volume of imports. The net result was to drive our trade deficit to a rate of close to $150 billion by the end of last year and to about $125 billion for the year as a whole.

No doubt, given the extreme values the dollar had attained internationally in 1984 and early 1985, an adjustment in exchange rates has been a necessary part of achieving a better competitive equilibrium and of responding to destructive protectionist pressures. That was explicitly recognized in the meeting of the Finance Ministers and Central Bankers of the five leading industrialized countries in September. By now, a substantial adjustment in exchange rates has been made, placing our producers in a stronger competitive position.

But we also know, from hard experience here and abroad, that changes in actual trade flows necessarily lag changes in exchange rates by a period extending into years, that currency adjustments can assume a momentum of their own, and that sharp depreciation in the external value of a currency carries pervasive inflationary threats.

No doubt, some depreciation in the dollar, after the rapid run up, could be absorbed without a sharp or immediate impact on domestic prices. But we cannot afford to be complacent. Inevitably, prospects for balance in our internal capital markets -- and therefore prospects for interest rates -- remain for the time being heavily dependent on the willingness of foreigners to place huge amounts of funds in dollars and on the incentives for Americans to employ their money at home. In essence, the financing of both our current account deficit and our internal capital needs -- so long as the government deficit remains so high -- is dependent on an historically high net capital inflow. Clearly, the orderly balancing of our demands for funds with supply in those circumstances requires continued confidence in our currency.

I recognize and appreciate the importance of the efforts that the Congress and the Administration have made to place the budget deficit on a declining trend. I know that effort will continue to require the hardest kind of choices. But we can also see some of the potential benefits in improved market sentiment. The net result should be both to reduce risks of inflation and to make us less dependent on foreign financing in the years ahead.

At the same time, oil imports apart, improvement in our trade balance for the next year or longer is in large part dependent not on depreciation of our currency but on greater growth by our trading partners. More competitive pricing is of limited value when foreign markets are not growing strongly, and when producers abroad do not themselves have expanding, profitable markets at home.

Prospects in that respect remain quite mixed. There have been signs of somewhat stronger growth in Germany and elsewhere in continental Europe. However, it remains questionable whether that growth will in fact be strong enough to reduce appreciably continued high levels of unemployment, now averaging more than 10 percent for the continent as a whole. In Japan, where unemployment is historically at much lower levels, growth by those same historical standards is sluggish, with the appreciation of the yen itself a restraining factor.

As appropriately emphasized at the September G-5 meeting, a better world equilibrium, including more rapid improvement in our trade balance, is clearly dependent on structural and other measures to deal with the sources of the imbalances. The Gramm-Rudman-Hollings legislation represents one important approach to that end. Stronger growth patterns in other leading countries are also directly relevant. The opportunities for policies to work toward that result this year appear to be greatly enhanced by the strongly beneficial effects of the declines in oil prices and the appreciation of their currencies. Both developments reinforce the already strong prospects for price stability in those countries.

Should oil prices remain close to present levels, that development will also be a powerful force offsetting, and in the short-run probably more than offsetting, the direct and indirect effects of the lower international value of the dollar on our overall price performance. At the same time, the effect is to release real purchasing power and cash flow to American consumers and oil-consuming businesses. The potential addition to real consumer income should work in the direction of offsetting the effects on purchasing power that some have foreseen in the full implementation of the deficit reduction program called for by the Gramm-Rudman-Hollings legislation over the course of this year.

With similarly beneficial effects for other consuming countries, that is part of the basis for a sense of growing optimism about world economic prospects. But, of course, the effects are sharply adverse for energy producers, affecting important regions in the United States where energy production and exploration loom so large, and therefore prospects for investment as a whole. The added strains for certain already heavily indebted developing countries are even more acute. Moreover, the pervasive pressures on much of the agricultural sector in this country remain, although recent legislation by the Congress addressed and should help stem further deterioration.

These sectoral strains and imbalances point up the crucial importance of maintaining the essential safety and soundness of our financial system, and in particular our depository institutions. For a long time, that was something we in this country thought we could take for granted. And it was partly that feeling, combined with accelerating inflation and other factors, that contributed to much more aggressive lending behavior over the years -- lending that has led to unanticipated problems in a period of disinflation and greater competitive pressures. Today, measures to protect the basic financial fabric necessarily assume a high priority, and that effort will require appropriate action by the Congress as well as the regulatory authorities.

Finally, in surveying the economic setting for monetary policy, I must call to your attention the disappointing record with respect to productivity over recent years viewed generally, at least as recorded by the standard national statistics. Developments in that respect during 1985, when productivity for nonfarm businesses as a whole showed no growth, are hard to explain. In manufacturing, where recorded performance is substantially better than in other sectors, the slower productivity growth may be a reflection of the levelling of output. But other sectors were growing relatively fast, without reflection in productivity improvement.

Perhaps part of the seeming problem lies in the inherent difficulty in measuring the volume and quality of output in the dominant service sector of the economy. But the results do raise further questions about the growth potential of the economy as recorded by the GNP statistics -- how fast can we expect the GNP to grow in a sustained way without excessive pressures on human or physical capacity. Over the past six months, for instance, the unemployment rate has dropped by a full 1/2 percentage point -- desirable in itself but accompanied by a recorded annual rate of output growth of only 2-3/4 percent.

In the end, it is largely productivity that governs prospects for per capita income growth; together with growth in the number of workers, it sets a limit on our total economic growth. Fortunately, in developing monetary policies now, we do not need to reach precise judgments about our long-term growth potential; today, capacity utilization is still somewhat below, and unemployment somewhat above, average levels for periods of business prosperity. Recent productivity trends, nonetheless, do introduce an unwelcome cautionary note about the longer-run.

Monetary Policy

Any description of the opportunities and risks in the current economic situation points up the fact that the formulation and implementation of monetary policy need to take account of a variety of sometimes conflicting objectives and criteria. In the current setting, other policy approaches -- toward the budget, toward international finance, toward trade, and toward other areas --

are obviously critical to the success of the common effort, just as the pervasive and indirect effects of monetary policy can bear upon the success of other policies beyond the strictly financial. Moreover, institutional and economic changes have strongly affected the behavior of certain policy guideposts -- notably M1 and debt -- relative to other economic magnitudes. Consequently, I do not believe that in current circumstances there is any escape from the need for a substantial element of judgment in the conduct of Federal Reserve policies.

That need was illustrated in 1985. Over the course of the year, monetary policy remained in a generally accommodative mode in the sense that pressures on bank reserve positions were both limited and little changed. The discount rate was reduced once in the spring, from 8 to 7-1/2 percent, and most market interest rates declined by 1 to 2 percentage points, generally reaching the lowest levels since mid-1979 or before.

As illustrated in Charts II and III attached, the broader monetary aggregates, M2 and M3, remained generally within the ranges targeted at the start of the year. At the same time, however, the narrowly defined measure of the "money supply," M1, grew persistently above the range set both at the start of the year and again after the range was reset in July (see Chart I). That aggregate ended the year almost 12 percent above the year earlier level, an historically high rate of growth.

In technical terms, that large "overshoot" was permitted in the light of a persistent and sizable decline in M1 "velocity" -- that is the relationship between M1 and the nominal GNP. That decline in velocity was apparent whether measured contemporaneously or with a one or two quarter lag between money and GNP. In other words, the exceptional growth in M1 seemed to be matched by an equally exceptional decline in velocity, suggesting the high M1 growth in 1985 does not imply the same inflationary potential, at least for the near term, as in the past.

Less abstractly, the judgment of the Federal Open Market Committee as the year developed was that the rather strong restrictive action that would have been necessary to maintain M1 within its targeted range was not justified in the light of the different signals conveyed by the much more restrained growth in M2 and M3, the slower growth in overall economic activity, the margins of capacity that remained, and the continuing progress toward price stability. For much of the year, the dollar remained high, and that fact was another strong signal that monetary policy was not unduly liberal.

We were aware, of course, of some conflicting evidence. During much of 1984 and 1985, domestic demand -- the spending of consumers, businesses, and governments -- continued to expand at a rate well beyond the rate of domestic output, measured by the GNP. In fact, the rate of demand increase, if maintained, would probably be beyond our long-term growth potential. In that sense we continued to live beyond our means, at the expense of a widening trade deficit.

Moreover, private as well as public debt continued to accumulate at an historically rapid rate, running above the

9-12 percent "monitoring range" set out at the start of the year. The aggregate debt statistics, portrayed in relation to GNP on Chart IV, exaggerate the problem to some degree. There has been massive issuance of tax-exempt securities in anticipation of tax law changes, for re-investment in Treasury securities in pending subsequent refundings, and for a variety of projects requiring new capital. Many of these activities lead to "double counting" in the aggregate statistics because both the new municipal debt and the debt acquired in employing the funds borrowed are included in the total. At the same time, substitution of debt for equity by businesses continued unabated, with about $100 billion of equity retired by a combination of stock repurchase programs, so-called leveraged buyouts, and as part of mergers and acquisitions.

The strongly rising stock market and lower interest rates had the effect of greatly increasing consumer wealth, measured by current market values, and lowering the cost of capital to business. Nonetheless, the trend of debt creation, with its implications of greater leveraging and potential financial fragility, remains disquieting, particularly in an environment of progress toward greater price stability. Indeed, as I suggested earlier, there is already ample evidence in the financial area of the consequences for individual institutions of extended financial positions and unduly loose credit standards. The crises in the thrift industry in Maryland and Ohio, where federal insurance and supervision were absent, illustrated in an extreme form the consequences of essentially speculative lending and lax market practices.

A more pointed question for the deliberations of the FOMC has been the lasting significance of the sizable increase in M1. We are well aware, as I have often reported to this Committee, of the long history and of the economic analysis that relate excessive money growth to inflation over time. The operational question remains as to what, in specific circumstances, is in fact excessive in the light of recent velocity behavior.

That question is greatly complicated both by the changed composition of M1, which now includes accounts that receive interest close to market levels and clearly have a large "savings" as well as a "transaction-oriented" component. The disinflationary process and the associated decline in market interest rates also have implications for the willingness to hold money.

Enough evidence has now accumulated since the peak inflation years to suggest two conclusions:

(1) That the long upward trend in velocity of 3 percent or so characteristic of most of the postwar period -- when inflation and interest rates were generally trending upward -- will probably not be typical of a world in which inflation and interest rates are trending downward and in which M1 has a growing savings component.

(2) That M1 may be more sensitive to short-term fluctuations in interest rates.

For 1985 specifically, our work strongly indicates that much of the unexpected decline in M1 velocity was a response to the sharp reduction in interest rates late in 1984, continuing at a lesser pace over much of last year. In a context of contained inflation, a generally strong dollar, and more muted economic growth, the decline in interest rates did not appear in itself to risk excessive economic stimulation, with renewed inflationary potential. Moreover, neither of the broader monetary aggregates, which remained within their target ranges, confirmed excessive monetary expansion.

Looking ahead to 1986, the FOMC decided to take account of the greater uncertainty associated with the relationship between M1 and economic activity and prices by adopting a relatively broad M1 target range of 3-8 percent. While wider, that range is centered on the same mid-point, 5-1/2 percent, as the tentative 4-7 percent range set out last July. In fixing that range, the Committee anticipated that velocity would not drop at nearly the rate of 1985. Without some reversal of the sharp drop in velocity last year, growth toward the upper end of the range could well be appropriate. More broadly, the Committee agreed that changes in M1 would be evaluated in the light of the presence -- or absence -- of confirming evidence of excessive growth in M2 and M3. For both those aggregates, the tentative growth ranges of 6-9 percent set in July were reaffirmed.*

As set out in Table II attached, in establishing these target ranges, members of the Federal Reserve Board and Reserve Bank Presidents anticipated the economy would grow somewhat more rapidly than in 1985 and that the unemployment rate would continue to decline gradually. Views on the outlook for prices were rather mixed, with some anticipating measurable further progress toward stability, particularly in the light of the oil price decline, while others expected that the consequences of the lower exchange rate may, for a time, put stronger upward pressure on prices. While the "central tendency" of the projections for real growth is lower than that of the Administration, so are most of the projections of prices by participants in the FOMC. The differences are not so large as to suggest, in themselves, inconsistency with the monetary growth targets; indeed, several Board Members and Presidents anticipated real growth in the 4 percent area. I might also note the somewhat lower unemployment rate generally anticipated by the Committee participants suggests more limited productivity growth than implied by the Administration projections.

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*These new ranges, and the related monitoring range for debt, in comparison with ranges for 1985 are shown in Table I.

Monetary policy is implemented day-by-day and week-by-week by determining the appropriate degree of pressure on bank reserve positions in the light of monetary growth, judged in the context of the flow of information about the economy, the outlook for prices, and domestic and international financial markets, including the value of the dollar in the foreign exchange markets. In the latter connection, circumstances now are, of course, very different than during most of 1985. The potential inflationary implications of further depreciation of the dollar, while likely to be offset for some time by lower oil prices, need to be fully considered in the implementation of policy.

At present, with the various monetary aggregates at reasonable levels relative to their new target ranges, and taking account of the cross-currents in other factors bearing on policy implementation, there has been no occasion for significant change in the degree of pressure on bank reserve positions. As you know, both intermediate and long-term interest rates have been declining to the lowest levels seen in years and the stock market has been ebullient. The justification, and the sustainability, of those developments lies in a combination of prospects for budgetary restraint, the favorable impact of lower oil prices, and improved inflationary expectations and performance. The challenge for monetary policy, insofar as it can contribute, is to help assure that those favorable prospects for maintaining progress toward stability can be a reality in the context of a growing economy. The implementation of policy will be conducted in the light of that objective.

Related Approaches

I referred earlier to the pressures in some areas of the credit markets growing in large part out of the backwash of overly aggressive lending policies in the earlier climate of accelerating inflation. Indeed, those concerns have been aggravated in more recent years by a continued highly aggressive approach by some institutions seeking high returns, with their own liabilities effectively underwritten by federal insurance. These problems, and appropriate responses to them, are too large a subject for me to deal with in the time available today; we have discussed them before on a number of occasions.

I do want to report, however, that the Federal Reserve has underway a number of initiatives to help deal with the problems more effectively. They include strengthening our force of examiners and supervisory personnel so that they are equipped to meet higher standards in the frequency and intensity of examination of member banks and holding companies. Certain regulatory steps have been undertaken as well. Specifically, we have issued for public comment a proposal for a framework of "adjusted capital/asset ratios" designed to supplement our present capital standards. The proposed standards are designed to take account of the different characteristics of bank assets and to incorporate allowance for off-balance sheet risks that have been proliferating rapidly at major banks here and abroad in recent years. I know other regulatory agencies have comparable initiatives underway in the supervisory and regulatory area.

By its nature, this supervisory effort must be a continuing process, although it has particular relevance in this turbulent period.

Moreover, I can only emphasize to you again my long-standing concern that you act, and act soon, to modernize our basic laws governing the structure and nature of our depository system. After decades of little change in the legal structure, technological and market developments have together created a new competitive environment. That change, without a coherent legislative framework, has sown enormous confusion about the proper and legitimate role of banks, bank holding companies, thrift institutions, and their commercial and financial competitors. Regulatory decisions attempting to apply current laws, sometimes conflicting in themselves, are regularly challenged in the courts. The results are capricious as both regulatory bodies and the courts inevitably reach different conclusions in ambiguous circumstances.

The courts themselves in recent decisions have emphasized the need for fresh Congressional guidance. I can only reiterate my own view that, without such a review, the banking and thrift industries are left adrift, driven to exploit perceived loopholes in present law on the one hand, while on the other hand, their basic and regulated business is undercut by commercial organizations and investment houses operating without the protections provided by the federal "safety net." The result is a clear threat not only to the coherence but also to the safety and soundness of the whole. Time is growing short.

From another perspective, the decline in oil prices has presented an enormous new challenge to a few countries that have been heavily dependent on oil resources for the development of their own economies. The problem is particularly acute with respect to Mexico, with which we have close trade and financial relationships, but it is certainly not limited to that country.

In the broadest terms, the initiatives outlined by Secretary Baker some months ago for managing a "second stage" of the international debt crisis provide a constructive and needed overall framework for dealing with problems. He emphasized the importance of achieving a solution in the context of overall financial and economic policies conducive to sustained growth. That, in turn, requires complementary actions by the borrowing countries, by creditors, and by multilateral development institutions alike.

In essence, the borrowing countries themselves -- "Baker Plan" or not -- appear to have the strongest kind of incentives to take those actions necessary to improve the efficiency and competitiveness of their own economies, including the development of their potentially vast non-oil resources. Those fundamental measures will be more effective, with faster results, to the degree those nations also have greater assurance of access to growing external markets for their products. Resistance to protectionism should, of course, be easier to achieve in a context of an expanding world economy, the prospects for which should be enhanced by the same decline in oil prices that makes the pressures more acute for oil producing countries.

The restructuring process can be greatly assisted by cooperation with such institutions as the World Bank and Inter-American Development Bank, which have funds available for substantially larger loan programs in support of fundamental economic adjustments, and with the International Monetary Fund. On that basis, I believe necessary margins of external private investment or loans can continue prudently to be made available to meet essential external needs. Indeed, without complementary policies by international institutions and creditors, the will to find constructive outward-looking solutions to the problems by the borrowers themselves will inevitably be undermined, and the adverse implications would extend far beyond the economic arena.

For some heavily indebted countries that either import a sizable portion of their energy requirements or are essentially neutral in that respect, recent developments should ease the task. But I do not in any way want to minimize the challenge for others -- for Mexico, Ecuador, Nigeria, and Venezuela. What I do suggest is that the fundamental premises of the total effort by borrowers and creditors alike in managing the debt situation remain valid. I believe that, with will and wisdom, the basis remains for working through this inevitably difficult period in a way that ultimately will reinforce prospects for longer-term growth.

Conclusion

I conclude as I started.

With constructive policy responses, recent developments carry the potential for enhancing prospects here and elsewhere for a sustained period of growth in a context of price stability. Those are the common goals of the Congress, the Administration and the Federal Reserve.

But if those goals are to be actually achieved, we also must clearly recognize, and collectively deal effectively with, points of strain and danger, some of them stemming from the very successes of the past.

-- Economic history is replete with examples of countries that, in attempting to correct overvaluation of their currencies, failed to take advantage of their improved competitive positions. Too often, they lapsed into a debilitating and self-defeating cycle of external depreciation and internal inflation, at the expense of an eroding loss of confidence, higher interest rates, and impaired growth.

It would be foolish to presume that the United States is somehow immune from that threat -- we had too much adverse experience in the 1970s to indulge in wishful thinking in that respect. Instead, in our monetary and fiscal policies, we need to be realistic about the danger and be fully sensitive to the need to maintain confidence in our currency.

-- Fortunately, the sharp decline in energy prices now underway should, for months ahead, help assure satisfactory price performance overall, making the job of maintaining progress toward stability much easier. But those lower prices are no unmitigated blessing.

They create new uncertainties and stresses for some regions of the economy, for some financial sectors, and particularly for some important developing countries and trading partners. Those stresses need to be contained and dealt with in a constructive way, and we need to guard against conditions that might lead to a repetition of past energy shortages.

-- The sense of greater confidence about our fiscal prospects still needs to be converted into reality. Whatever the fortunes of the Gramm-Rudman-Hollings legislation in the courts or the merits of that particular approach toward the problem, the direction and broad spirit of the effort is essential if we are to correct deep-seated imbalances that, sooner or later, would only undercut our bright prospects.

-- The success of all our efforts is dependent in substantial part on complementary policies by other countries -- their success in enhancing their growth and stability, in opening markets to others, and in helping to deal with points of strain in the international financial fabric.

Most other industrialized countries have, as a matter of priority, been deeply concerned with restoring price stability and reducing fiscal deficits. Remarkable strides have been made toward those goals. However, their growth, at least until now, has been heavily dependent upon rising trade and current account surpluses. Today, there appears to be a prime opportunity for encouraging "home grown" expansion, larger imports, and better international balance.

-- For the longer run, I welcome the call by the President to consider what steps might be desirable to achieve and maintain greater exchange rate stability internationally.

No one should think that task is a simple one. It cannot in any way substitute for disciplined and complementary domestic policies among the leading nations. Indeed, meaningful progress would imply even greater demands on those policies and on international cooperation. But surely we have had enough experience, here and elsewhere, with the distorting effects of extreme exchange-rate volatility to make that effort to reexamine the international system worthwhile. In a fundamental sense, that is a corollary of the simple observable fact that the economic fortunes of all countries -- including the United States -- are inextricably interlocked.

We have come too far, and the stakes are too high, to fail to rise to the evident new challenges.

We have to recognize that depreciation of our currency does not in itself provide a fundamental solution, and is in fact a two-edged sword.

The budgetary effort must be sustained.

If we expect to benefit from the break in energy prices, we must collectively respond to the points of strain.

We need to be patient when patience is required. The trade and budgetary and financial problems will be with us for some time; at the same time, we need to be insistent in carrying through the measures to deal with them constructively.

In much of this, I recognize the Federal Reserve and monetary policy have a vital part to play. Given the cross-currents in the economy and sometimes conflicting signals among the guideposts to policy in today's setting, there will be a high premium on careful judgment. But through it all the basic objective does not change. We are convinced that sustained growth in the United States -- and much more -- is dependent upon maintaining progress toward price stability over time. And given our weight in the world, that same stability must be one of the foundation stones of a prosperous, integrated global economy.

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Chart 2

M1 Target Ranges and Actual

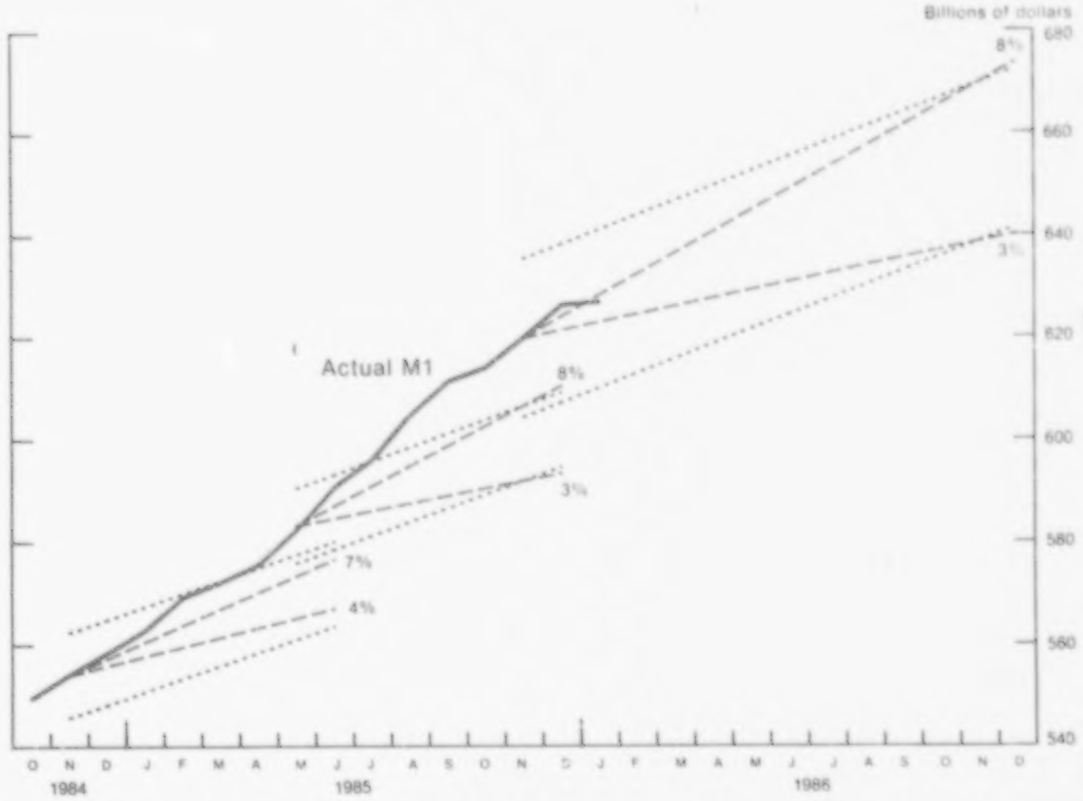

Chart II

M2 Target Ranges and Actual

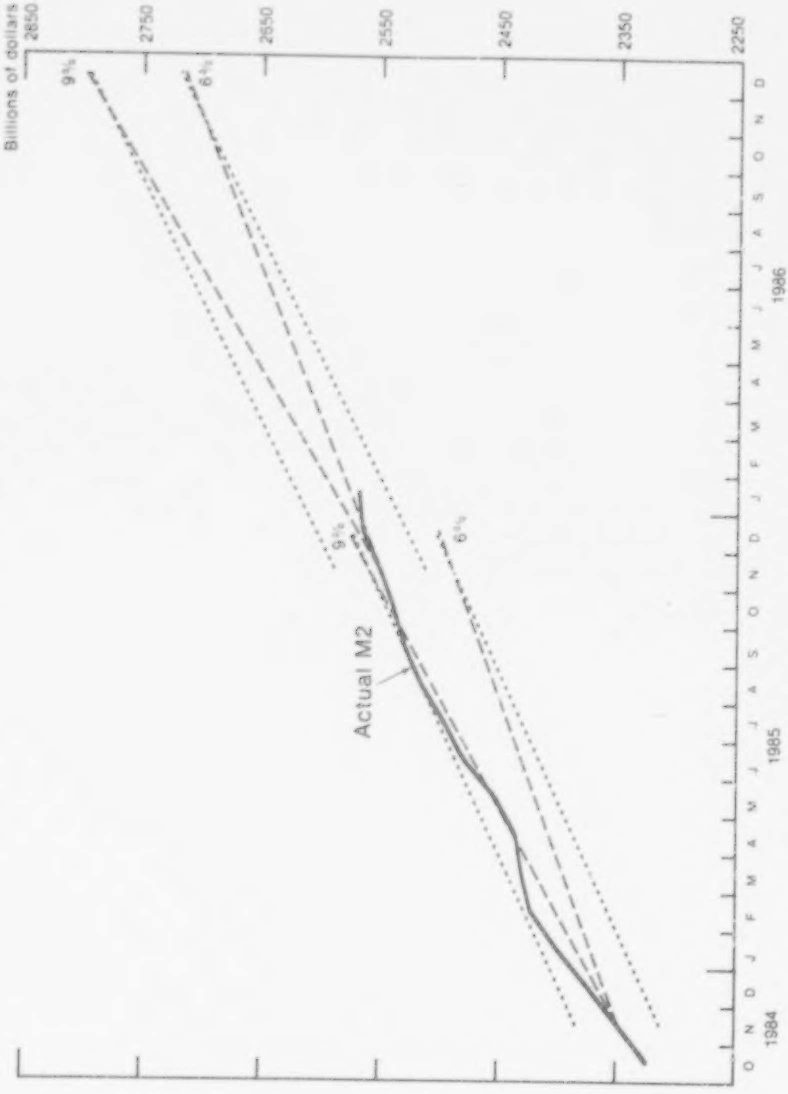

Chart III

M3 Target Ranges and Actual

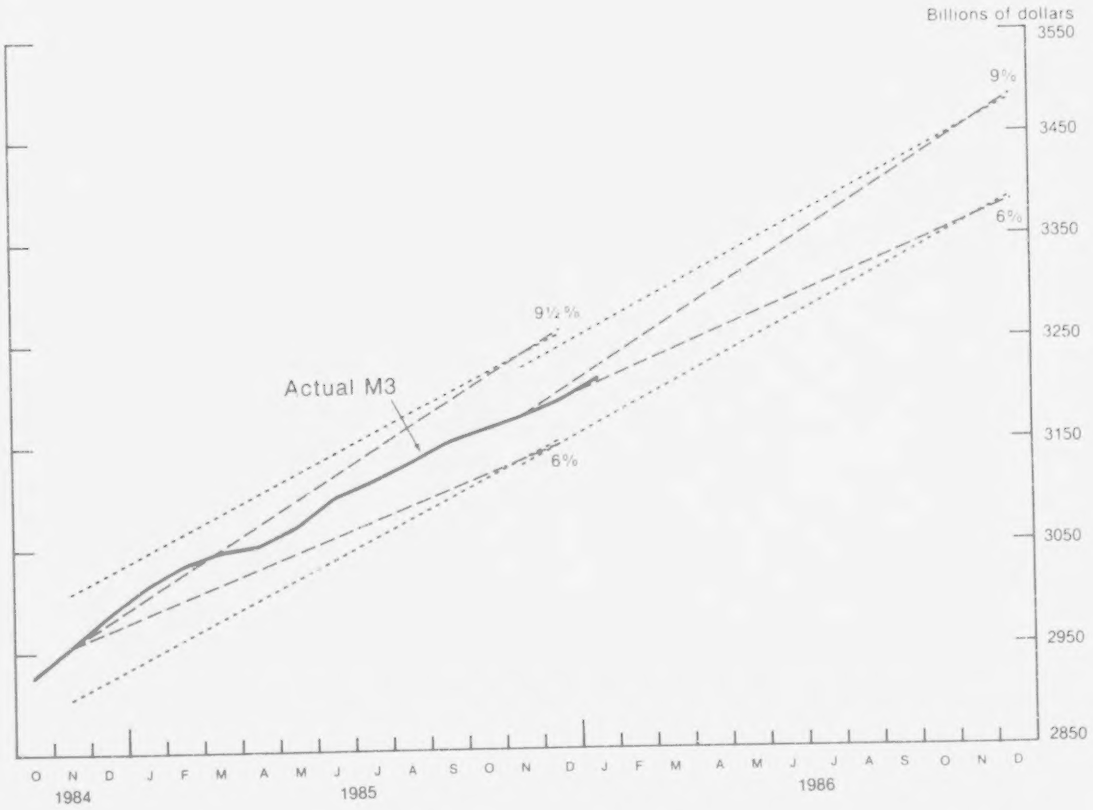

Chart IV

Ratio of Domestic Nonfinancial Sector Debt to GNP

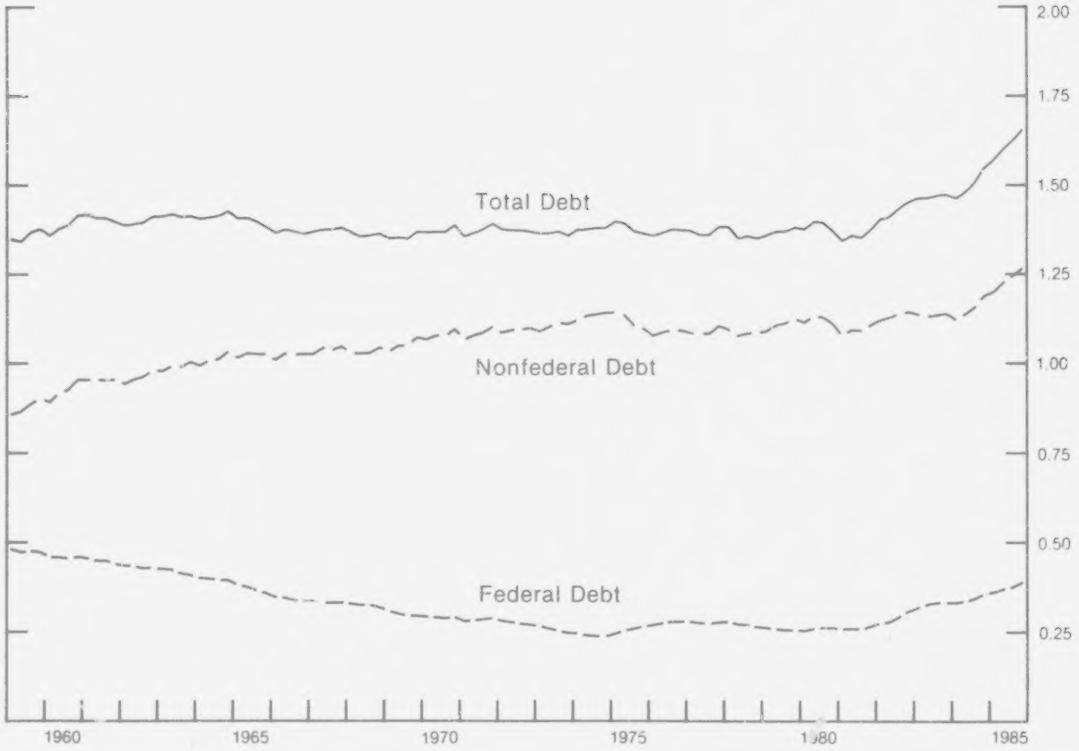

Table I

Ranges of Growth for Monetary and Credit Aggregates
(Percent change, fourth quarter to fourth quarter)

	1986	1985
M1	3 to 8	3 to 8*
M2	6 to 9	6 to 9
M3	6 to 9	6 to 9-1/2
Debt	8 to 11	9 to 12

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*Applied to period from second to fourth quarter.

Table II

Economic Projections for 1986

	FOMC Members and other FRB Presidents		Administration	CBO
	Range	Central Tendency		
Percent change, fourth quarter to fourth quarter:				
Nominal GNP	5 to 8-1/2	6-1/2 to 7-1/4	8.0	7.6
Real GNP	2-3/4 to 4-1/4	3 to 3-1/2	4.0	3.6
Implicit deflator for GNP	2-1/2 to 4-1/2	3 to 4	3.8	3.9
Average level in the fourth quarter, percent				
Unemployment rate	6-1/4 to 6-3/4	About 6-1/2	6.7	6.7*

*Civilian unemployment rate.

For use at 10:00 a.m., E.S.T.
Wednesday
February 19, 1986

Board of Governors of the Federal Reserve System

Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

February 19, 1986

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., February 19, 1986

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

Section 1: Monetary Policy and the Economic Outlook for 1986

While there are unusual uncertainties surrounding prospects for prices and economic activity in 1986--stemming in part from questions about the timing and dimension of domestic adjustments to the weaker dollar on exchange markets, about oil price declines, and about the process of fiscal restraint--the overall economic outlook for the year appears generally favorable. Real economic growth probably will pick up somewhat from last year's pace, and inflationary pressures should remain contained. The recent weakness in oil prices, though it has the potential for causing dislocations in energy markets and adding to the strains on some heavily indebted oil-producing countries, should enhance real growth and work to offset the upward impact on the price level this year from the drop in the dollar on exchange markets. Over the course of the year, the prospective movement toward fiscal restraint, and also the more competitive exchange rate, should help correct imbalances that in recent years have threatened the sustainability of economic expansion and affected domestic and international financial markets.

Economic and Financial Background

The past year was one of further progress in the national economy. Although growth in economic activity was slower than in the earlier phase of the expansion, increases in output were great enough to reduce the unemployment rate to its lowest level since 1980. Moreover, even as the economic upswing moved into its fourth year, inflationary pressures remained in check. In 1985, prices generally rose less than the year before and wage gains were restrained.

Continued economic growth last year was supported by a generally accommodative monetary policy. The demand for narrow money was strong, partly in lagged response to earlier interest rate declines and partly perhaps in response to more conservative cash management practices. M1 expanded relatively rapidly throughout the year, growing about 12 percent, and its velocity exhibited an unusual and large drop of 5-1/2 percent; growth exceeded both the original target range set in February and the wider, rebased range for the second half set in July. However, the broader monetary aggregates behaved more normally and ended the year within their target ranges. M2 expanded about 8-1/2 percent as compared with its 6 to 9 percent range, and M3 grew around 7-1/2 percent compared with its range of 6 to 9-1/2 percent.

In credit markets, most short-term interest rates declined about a percentage point over last year, while longer-term rates dropped approximately 2 percentage points, partly reflecting an improved outlook for inflation and expectations of greater fiscal restraint. Stock prices also rose substantially during the year. Meanwhile, debt growth was strong, with expansion of domestic nonfinancial debt for the year of 13-1/2 percent, above the monitoring range of 9 to 12 percent set by the Committee. The rapidity of debt creation reflected, in part, borrowings to finance retirements of corporate stock associated with mergers, buy-outs, and share repurchases and the acceleration of state and local debt issues in response to proposed tax law changes.

While output of the U.S. economy, measured by real GNP, expanded moderately in 1985, domestic sectors increased their purchases of goods and services more rapidly. The difference was reflected in an increasing volume of imports as the volume of exports declined. Thus, all segments of the economy did not share equally in the expansion. Key sectors such as manufacturing, mining, and agriculture continued to face strong competition from foreign producers. Sluggish growth abroad also limited export markets for U.S. producers. In financial markets, a number of institutions had to cope with loan problems associated with the economic pressures and large debt burdens of certain borrowers, including less developed countries and energy and agricultural borrowers in the United States.

Adjustments are in process that should help correct the imbalances that have emerged in recent years. The resolve demonstrated by Congress and the Administration in passing the Balanced Budget and Emergency Deficit Control Act of 1985 has had salutary effects on expectations in financial markets. As budgetary deficits are reduced, more and more domestic saving can be channeled into investment in the plant and equipment needed to improve productivity and sustain economic growth over the long term. The decline in the dollar should help bring about an environment in which U.S. producers will be able to compete more effectively in world markets. The efforts of many banks and other financial intermediaries to bolster capital and reserves, together with lower interest rates, should help financial institutions to strengthen their ability to cope with financial strain. Questions remain, however, about other factors affecting the U.S. economy--including the strength of economic expansion abroad, the impact of a declining dollar on inflation here, and the effect of reduced oil prices on the financial health of domestic energy producers and of a number of oil-exporting developing countries.

Monetary Policy for 1986

The Federal Open Market Committee framed its monetary policy plans for 1986 in light of the fundamental objectives of maintaining sustainable growth of economic activity, making continued progress over time toward price stability, and working toward better balance in the nation's external transactions. As shown in the table below, the Committee set ranges for the monetary aggregates for the period from the fourth quarter of 1985 to the fourth quarter of 1986 of 3 to 8 percent for M1 and 6 to 9 percent for both M2 and M3; it established a monitoring range of 8 to 11 percent for debt. These are the same ranges as had been tentatively set for 1986 in July of last year, except that the M1 range has been widened to reflect the uncertainties about the behavior of that aggregate, as noted below.

Ranges of Growth for Monetary and Credit Aggregates
(Percent change, fourth quarter to fourth quarter)

	1986	1985
M1	3 to 8	3 to 8*
M2	6 to 9	6 to 9
M3	6 to 9	6 to 9-1/2
Debt	8 to 11	9 to 12

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* Applied to period from second to fourth quarter.

As compared with ranges that had most recently been in effect for 1985, the new ranges involve a reduced upper limit for M3 and a generally lower range for debt. The ranges for M1 and M2 are unchanged. The width of the M1 range reflects continuing uncertainties about the behavior of M1 under varying economic and financial circumstances, given recent experience and the changed composition of the aggregate over the past few years. In particular, the availability of interest-bearing checking accounts that serve both transaction and savings functions may have increased the sensitivity of this aggregate to changes in market rates as well as to other factors influencing the public's allocation of its savings among various financial assets. While the range for M1 is wide enough to allow for some variation in behavior of the aggregate's income velocity in response to changing conditions, the range was set on the assumption that there would not be a large drop in velocity, such as occurred in 1985. In that connection, the Committee will evaluate behavior of M1 in light of its consistency with the other monetary aggregates, economic and financial developments, and the potential for inflationary pressures. In sum, policy implementation will involve continuing appraisal of the relationships among the various measures of money and credit, their velocity trends, indicators of economic activity and prices, as well as conditions in domestic credit and foreign exchange markets.

The growth of the broader aggregates in 1986 is not expected to be far different from last year, when their velocities declined somewhat. Last year's velocity experience was closer to the norm for these aggregates than was the case for M1. The final phase of deposit deregulation this year--the removal of minimum balance requirements on money market deposit accounts at the beginning of the year and the elimination of ceiling rates on savings and regular NOW accounts at the end of March--is expected to have only minimal effects on the broad aggregates as well as on M1. Other ceiling-free accounts have been widely available for a number of years, and minimum balance requirements already have been reduced to a relatively low level.

The Committee for some years has had a monitoring range for the total debt of domestic nonfinancial sectors. Historically, debt has expanded about as rapidly as GNP, but in recent years debt has grown more rapidly than the economy, raising some concern about the increasing debt burden. The growth of debt is expected to moderate somewhat in 1986. A diminution of debt financing for purposes of stock retirement is anticipated, and growth of state and local government debt is expected to slow from last year's exceptional pace, absent further changes in the proposed tax law that might prompt a renewed acceleration in borrowing. While the federal deficit is expected to remain at a high level for much of 1986, it should begin declining in the course of the year as greater fiscal restraint takes hold and helps to curb the rate of increase in U.S. government debt.

Economic Projections

The Committee felt that its monetary objectives were consistent with expectations for continued growth in output, further reductions in unemployment, and muted inflation in 1986. While there clearly are a good many uncertainties and risks in the present environment--for instance, the actual outcome for the budget, behavior of the dollar, and oil prices--the Committee members and nonvoting Reserve Bank Presidents generally believe that prospects for the economy in the year ahead are reasonably favorable. As indicated in the table below, their expectations center on real GNP growth of 3 to 3-1/2 percent and on inflation in the 3 to 4 percent range. The expanding job opportunities associated with the increase in output are expected to lower the unemployment rate gradually, although sluggish productivity performance, if it should continue, would limit the nation's growth potential.

Economic Projections for 1986

	FOMC Members and other FRB Presidents		Administration	CBO
	Range	Central Tendency		
Percent change, fourth quarter to fourth quarter:				
Nominal GNP	5 to 8-1/2	6-1/2 to 7-1/4	8.0	7.6
Real GNP	2-3/4 to 4-1/4	3 to 3-1/2	4.0	3.6
Implicit deflator for GNP	2-1/2 to 4-1/2	3 to 4	3.8	3.9
Average level in the fourth quarter, percent				
Unemployment rate	6-1/4 to 6-3/4	About 6-1/2	6.7	6.7*

*Civilian unemployment rate.

Two key factors in the positive economic outlook are the recent developments in energy and financial markets. The decline in energy prices can be expected raise the growth of real disposable income and bolster consumer spending in the months ahead. The marked increase in household financial wealth associated with the rise in stock and bond prices also should provide the basis for continued gains in consumer outlays. This should work to offset the restraint in spending that could be exerted by the runup in household indebtedness and the associated decline in the personal saving rate during the past year. Nevertheless, the high level of debt remains a risk in the outlook for consumer spending.

The rise in stock prices and decline in interest rates has improved prospects for domestic investment in plant, equipment, and housing. Moreover, as noted earlier, while the federal deficit is not likely to drop significantly for some months, greater fiscal restraint, as it develops, should enhance the availability of domestic saving for private investment and reduce the need to rely on foreign saving. Mortgage rates are at their lowest levels since 1979, and the greater affordability of housing can be expected to buoy residential construction even in the face of some evident overbuilding in the multifamily sector. Similarly, lower costs of capital should--along with some improvement in the competitiveness of U.S. industry owing to the dollar's decline--help to support business investment despite likely weakness in the energy and office building sectors. In the near term, the leanness of manufacturers' stocks suggests the likelihood of some pickup in the rate of inventory accumulation.

The outlook for the external sector is quite uncertain. The response of U.S. industry, as well as of foreign producers, to the decline in the dollar will take place only over time and will depend on a number of factors, such as the extent to which it is believed the exchange rate change is "permanent" and on the strategies firms pursue with respect to the potential trade-off between profit margin and market share. Perhaps more important in the short run, our trade and current account position also will depend on the pace of economic growth abroad: if growth in other countries is relatively slow, that would tend to limit near-term improvement.

With regard to the outlook for inflation, wages in the aggregate have shown no tendency toward acceleration and recent settlements in major collective bargaining agreements indicate wage gains in manufacturing, construction, and transportation are likely to continue at the moderate pace registered in recent years, even though the unemployment rate is declining. Disappointing productivity performance does raise questions about pressures from the labor cost side, although some pickup in productivity improvement is assumed this year. A decline in oil prices also should be a constructive influence. Nevertheless, it was recognized that a weaker dollar poses a clear risk of greater inflationary pressures.

The FOMC members' and nonvoting presidents' projections of real GNP and prices over 1986 generally are somewhat lower than the Administration's projections, although the full range of expectations does encompass the latter. In any event, differences are not large and economic growth at the pace the Administration anticipates can be accommodated by the FOMC's targets.

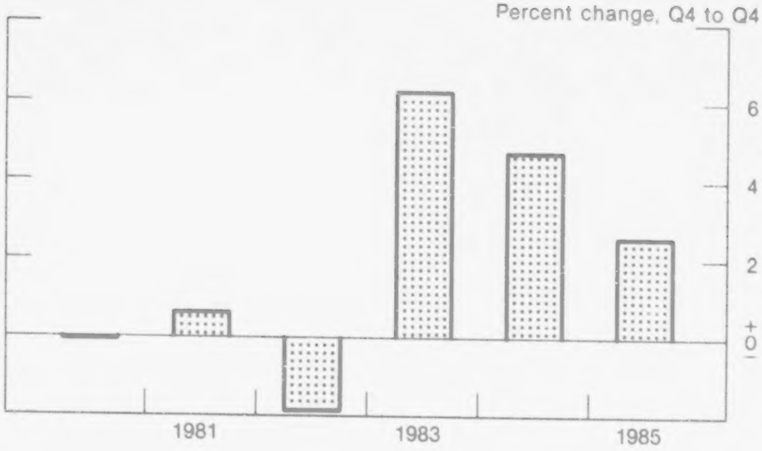
Section 2: The Performance of the Economy during the Past Year

The economy completed a third successive year of expansion in 1985, with the real gross national product increasing 2-1/2 percent over the year. The rise in economic activity was sufficient to create 3 million new payroll jobs and the unemployment rate edged down; with a further strong increase in employment in January of this year, the jobless rate for civilians reached a six year low of 6.7 percent. Meanwhile, most broad measures of price increase indicate that inflation slowed to about a 3-1/2 to 3-3/4 percent rate in 1985, somewhat less than the pace registered over the previous two years.

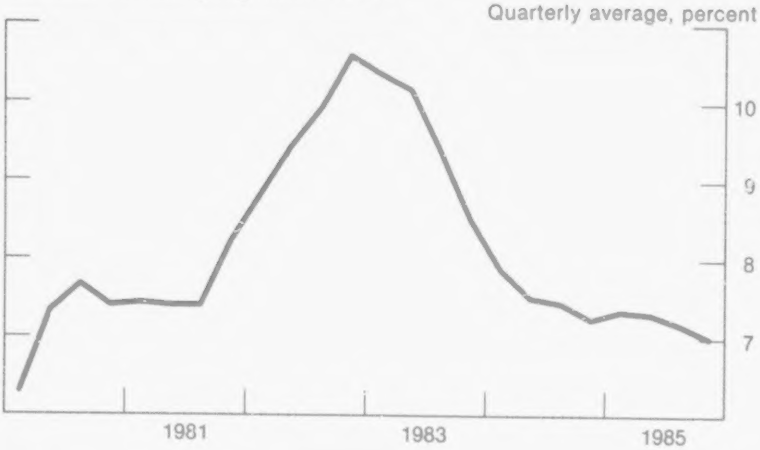
Though output and employment continued to grow in 1985, the rate of expansion was slower than some had anticipated, raising some concerns about the sustainability of the recovery. Furthermore, the pattern of developments in the past year had some disturbing aspects: domestic and foreign demands continued to be diverted away from goods and services produced in the United States, draining income from our households and businesses and exacerbating an inventory correction by U.S. firms as their sales lagged; meanwhile, consumers continued to increase their spending at a substantial clip, but only by borrowing at a pace that pushed household debt burdens to still higher levels.

Although the nation as a whole experienced continued growth, the serious sectoral imbalances that had emerged earlier during the recovery became more apparent when gains in activity moderated. Industrial output grew slowly in 1985, and manufacturing and mining employment posted outright declines during much of the year. The agricultural sector remained under

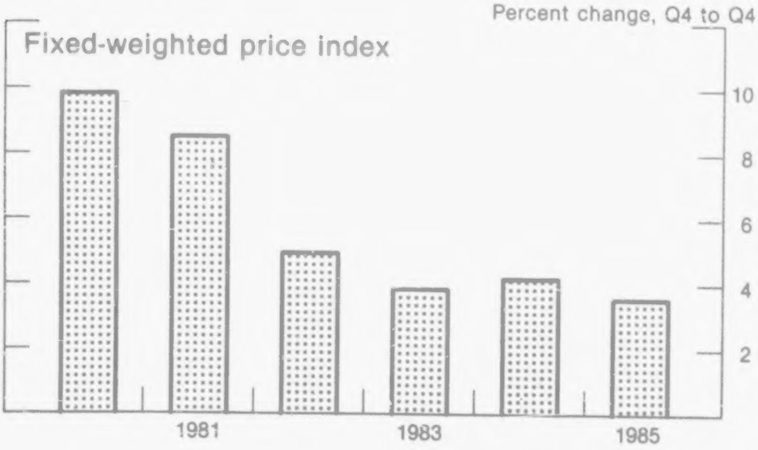
Real GNP



Civilian Unemployment Rate



GNP Prices



acute pressure, as shrinking export markets and abundant harvests pushed prices sharply lower. As a result, farmers continued to face mounting difficulties in servicing the large volume of debt that was accumulated in the 1970s.

To a considerable extent, these imbalances and stresses are related to fundamental disequilibria in the nation's finances: the continuing huge federal budget deficit and the growing deterioration in the U.S. current account. During the past year, however, policymakers took important steps to address these problems. The Balanced Budget and Emergency Deficit Control Act was passed, establishing a mechanism for deficit reduction and signaling the resolve of Congress and the Administration to achieve meaningful progress on this front. And the financial authorities of the G-5 nations agreed that exchange rates should better reflect underlying economic relationships, which would enhance the prospects for some improvement in our external balance.

The federal budget deficit was of record magnitude in fiscal year 1985. The large federal deficit not only absorbed a significant portion of the saving available to the domestic economy, but also continued to be a source of concern to investors with respect to longer-range potential for inflationary pressures. Not surprisingly, the prospect for some reduction in the deficit contributed to the downward trend in interest rates late last year.

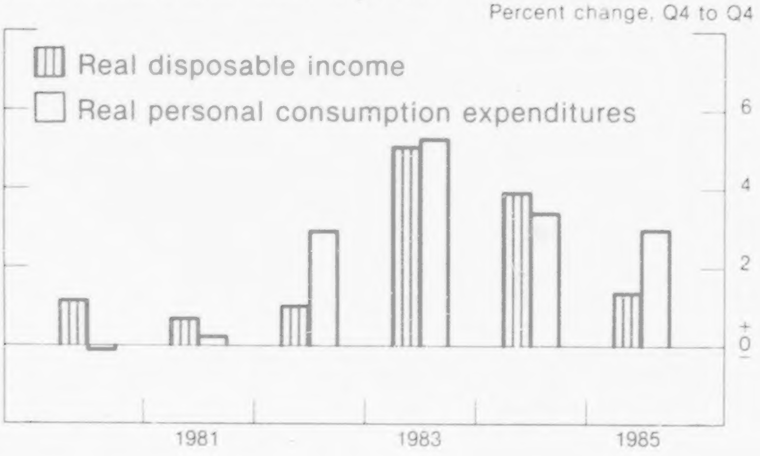
The importance of international economic developments for the performance of the U.S. economy has become increasingly apparent during the current economic expansion. Although the foreign exchange value of the dollar declined over most of the year--encouraged at times by coordinated official intervention activity--changes in spending patterns, which typically lag movements in exchange rates, were not yet evident and imports made further inroads into domestic markets. Meanwhile, slow growth, on average, in much of the rest of the world has failed to provide strong markets for U.S. exports. The net result has been that domestic demands have increased more rapidly than domestic production throughout the course of the expansion.

An important achievement of the current recovery has been the sustained expansion of economic activity without any relinquishing of progress toward the goal of price stability. The containment of inflation has been aided by the high exchange value of the dollar and excess world supplies of many basic materials, which have left prices unchanged or lower for a wide range of imported goods, industrial commodities, agricultural products and petroleum. More fundamentally, wage increases in the aggregate have been restrained, limiting upward pressure on costs.

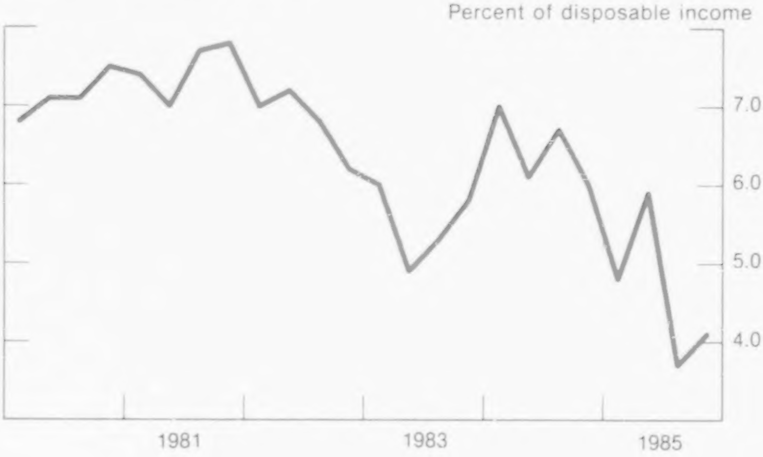
The Household Sector

Spending in the household sector remained strong in 1985, despite a sharp slowing in income growth. Growth in real disposable income rose about 1-1/2 percent, much less than the 4 percent increase of the previous year. Income growth was limited as wage and salary gains decelerated, interest income weakened and farm income plummetted. Meanwhile, real personal consumption expenditures advanced 3 percent last year--only a little less than in 1984--buoyed by continued high levels of borrowing. As a result, the personal saving rate fell to an average of about 4-1/2 percent last year, well below historical norms.

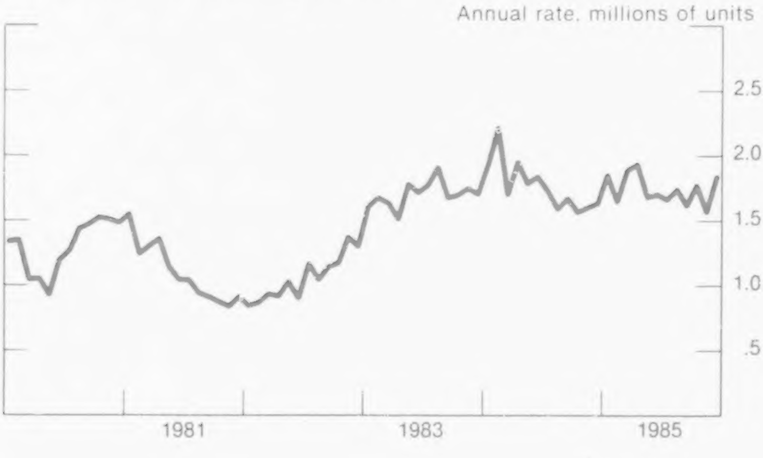
Real Income and Consumption



Personal Saving Rate



Total Private Housing Starts



The strength in household spending last year reflected further gains in outlays for consumer durables, especially purchases of new automobiles. Sales of new cars totaled more than 11 million units, the strongest selling pace since 1978. Sales of domestic autos picked up to 8-1/4 million units in response to the general downtrend in interest rates, several rounds of price and financing concessions offered by manufacturers, and increased availability of some models that had been in short supply in 1984. Sales of foreign cars climbed to a record level of more than 2-3/4 million units for the year; a greater volume of exports to the United States was permitted under the Japanese voluntary restraint program for 1985-86, and this accounted for most of the pickup.

Activity in the housing sector was flat in 1985. The number of new homes started last year remained at about the same 1-3/4 million unit rate posted in the preceding two years. Construction of single-family housing showed no new strength, despite a decline in mortgage rates to their lowest level in six years and favorable demographic trends. In part, some of the effect of lower mortgage rates may have been offset by a tightening of qualification standards by lenders and mortgage insurers and higher mortgage insurance premiums. Construction of multifamily housing remained at the relatively high level of the two previous years, notwithstanding high and rising vacancy rates for rental units. Rental housing construction was supported by heavy issuance of debt by state and local authorities, partly in anticipation of constraints imposed by tax reform legislation.

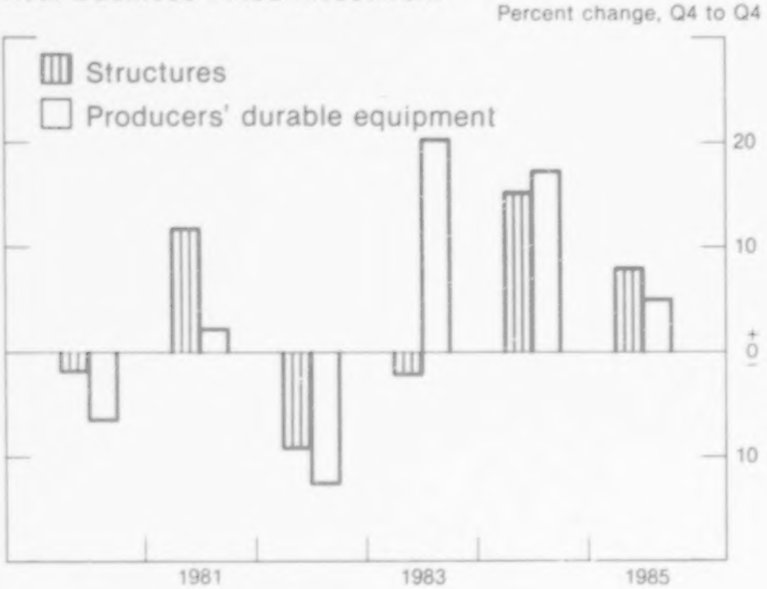
Recent trends in consumer balance sheets continued last year. Consumer installment debt, which had climbed sharply in 1984, did so again in 1985 and the ratio of debt to disposable income reached a record high. Growth in financial assets of households has, however, more than kept pace with the rapid rise in debt over the past two years. In particular, the strong gains posted by the stock and bond markets in 1985 provided a substantial boost to household wealth.

Indications of debt-servicing difficulties in the household sector have mounted. Delinquency rates on consumer installment loans have been on the rise since mid-1984, and for some categories--such as bank credit cards--have reached relatively high levels. Moreover, mortgage loan delinquencies persist at the historically high levels that have prevailed since the 1981-82 recession, associated with the influence of lingering high rates of unemployment in some communities, slow income growth, and weak housing prices in certain areas of the country. However, surveys of households continue to show favorable readings on attitudes concerning financial positions, suggesting these financial strains are currently limited to a small part of the population.

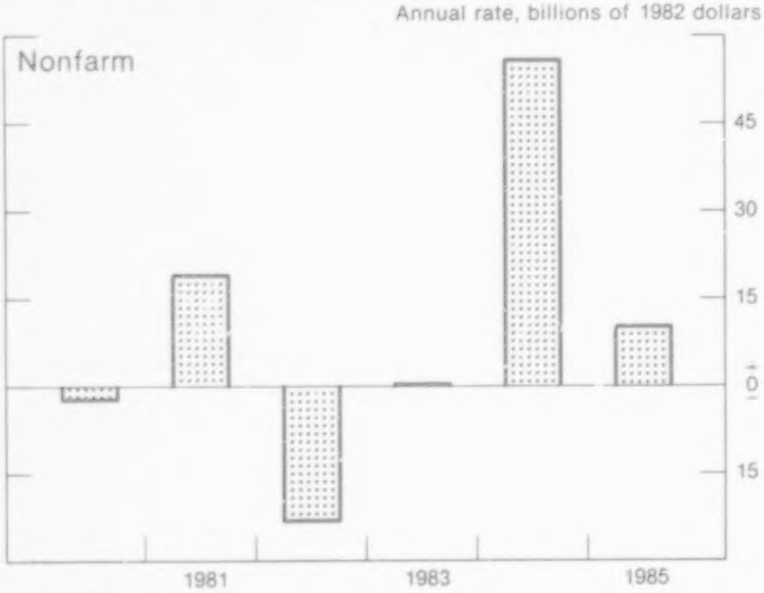
The Business Sector

Economic conditions in the business sector also were mixed last year. After-tax economic profits of nonfinancial corporations as a group increased sharply for a third consecutive year and as a percent of GNP stood at their highest level since the late 1960s. Many firms in manufacturing and mining industries, however, have encountered significant difficulties brought about by the high value of the dollar. In addition to the influence of the exchange rate, downward pressures on prices and profits in the agri-

Real Business Fixed Investment



Changes in Real Business Inventories



cultural and energy sectors have been exacerbated by ample supplies in world markets.

Business spending for equipment and structures advanced 6 percent in real terms in 1985, supported by falling interest rates, declining relative prices for capital equipment, and continued efforts to modernize facilities in order to meet intensified competition. Nevertheless, the growth in business fixed investment was well below the extraordinary pace of the preceding two years. Furthermore, the slowdown in capital outlays was widespread, including many categories of high technology equipment, heavy industrial machinery, and structures. Some deceleration of investment spending can be expected as an expansion progresses and the growth of sales subsides to more sustainable levels. However, the reduced pace of investment last year was reinforced by declining capacity utilization rates in the industrial sector. Moreover, rising vacancy rates for office buildings contributed to slower growth in expenditures for nonresidential structures.

Businesses accumulated inventories at a much reduced pace in 1985, particularly in the manufacturing sector. In real terms, nonfarm business inventories rose $10 billion last year, following the sharp $56 billion investment that occurred in 1984. In the manufacturing sector, sluggish orders and stable or falling prices have induced businesses to adopt a cautious approach to inventory accumulation; factory inventories declined over the second half of 1985 and were little changed on net for the year as a whole. In the trade sector, stocks increased over the year, boosted by a large rise in auto inventories in the fourth quarter. Excluding autos, inventories at retail establishments increased about in line with the moderate rise in sales over 1985.

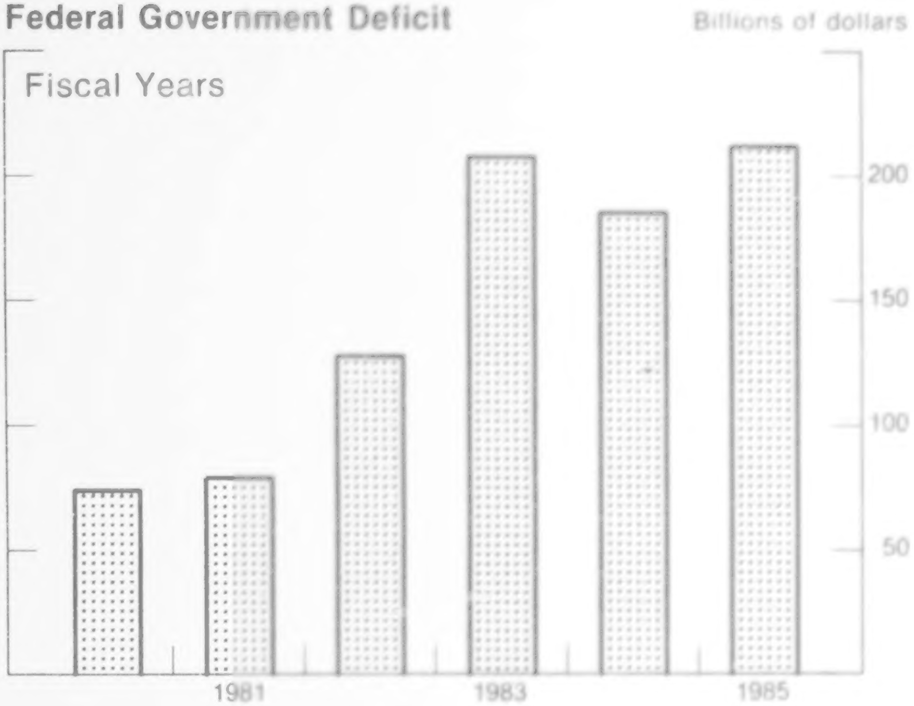
Financial strains have remained evident in several important sectors of the economy. The decline in the exchange value of the dollar has yet to ease significantly the international trading problems of many industrial firms. Moreover, the activity and earnings of the domestic energy sector have been affected adversely by the weakening of petroleum prices on world markets. The financial condition of U.S. agriculture worsened further in 1985. A large portion of the agricultural sector has continued to struggle with sharply lower prices, diminished export markets and depressed land values. With farm incomes plunging, debt-servicing problems have created serious strains on both farmers and farm lenders.

The Government Sector

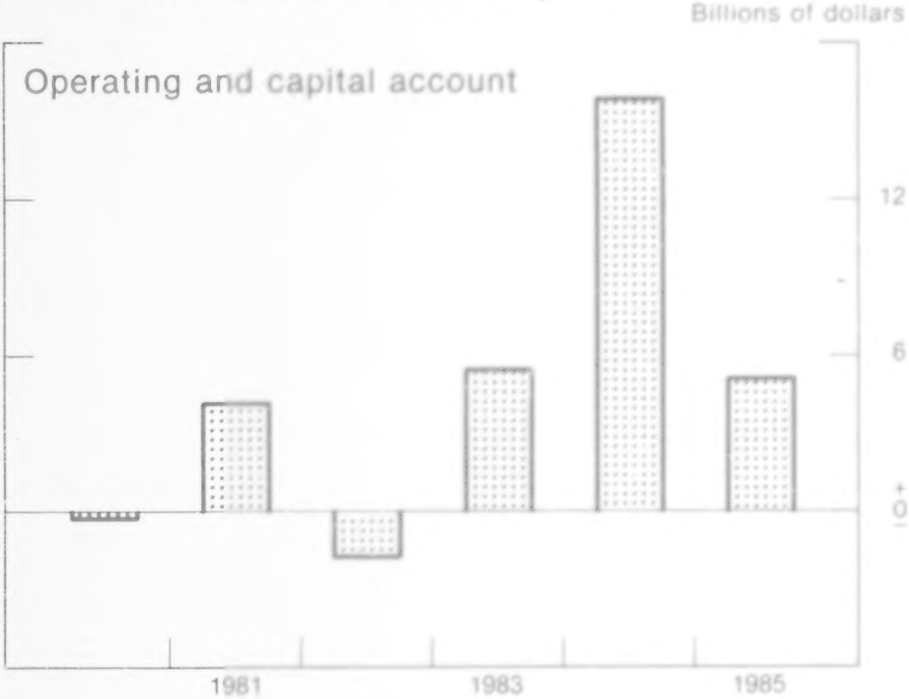
The federal budget deficit rose to $212 billion in fiscal year 1985. Although the expanding economy continued to boost receipts, outlays rose even faster, with large increases registered for agricultural support payments, interest outlays, and defense purchases. As a percent of GNP, the deficit remained at an historically high 5 percent level, absorbing a large share of the net saving available to the domestic economy.

Federal government purchases of goods and services, which add directly to GNP and constitute a third of total federal expenditures, posted another strong advance last year. Federal purchases, excluding changes in farm inventories held by the Commodity Credit Corporation (CCC), were up more than 3-3/4 percent over the year, after adjustment for inflation. Defense outlays continued to provide a major boost to federal purchases, rising 6-1/2 percent over the year. CCC purchases rose sharply, as low market prices encouraged farmers to shift massive inventories of grain to the federal government.

Federal Government Deficit



State and Local Government Surplus



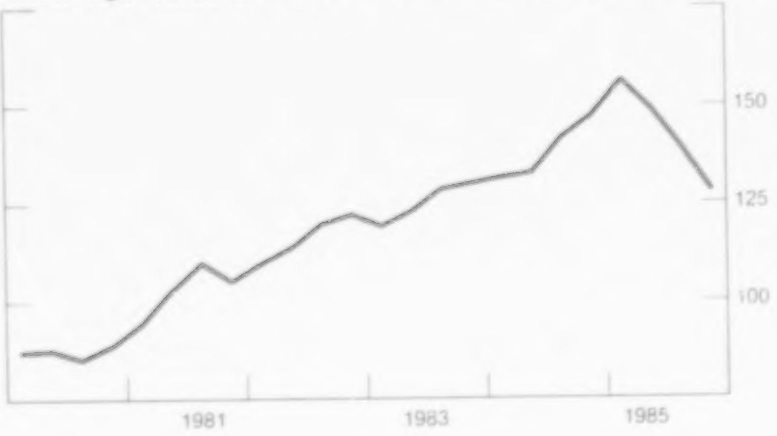
State and local governments increased purchases of goods and services about 3 percent in 1985, after a similar increase in the preceding year. Most of the growth in expenditures last year reflected strong increases in construction outlays as states and localities continue efforts to improve and expand basic infrastructure. With the rise in expenditures exceeding the growth in receipts, the fiscal position of state and local governments weakened throughout the year; aggregate operating and capital account surpluses, which had risen to substantial levels in 1984, were virtually eliminated by the end of last year.

The Foreign Sector

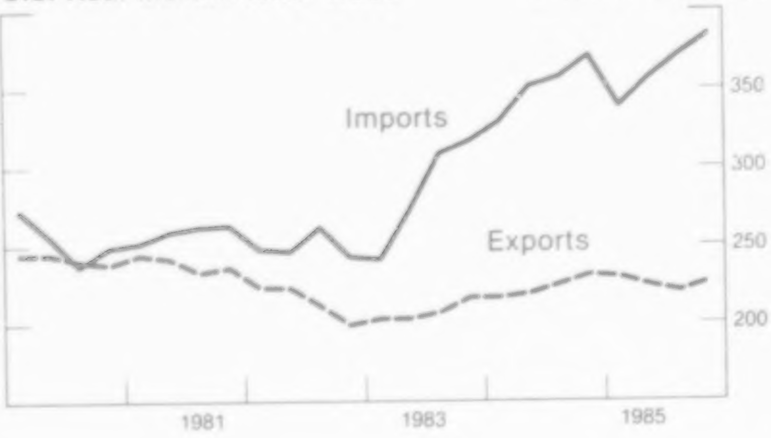
After registering particularly sharp gains toward the end of 1984 and in the first two months of 1985, the dollar generally fell in international currency trading throughout the remainder of last year. By the end of 1985 the trade-weighted foreign exchange value of the dollar had fallen nearly 25 percent from its peak in February. This decline occurred against the backdrop of a narrowing of the differential between inflation-adjusted long-term interest rates in the United States and other industrial countries, which at least in part reflected the slowing of economic growth in the United States relative to growth abroad.

It will take some time before the effects of the dollar's depreciation manifest themselves in the external position of the United States, which continued to deteriorate last year. The widening gap between imports and exports boosted the current account deficit to about $120 billion, up from $107 billion in 1984.

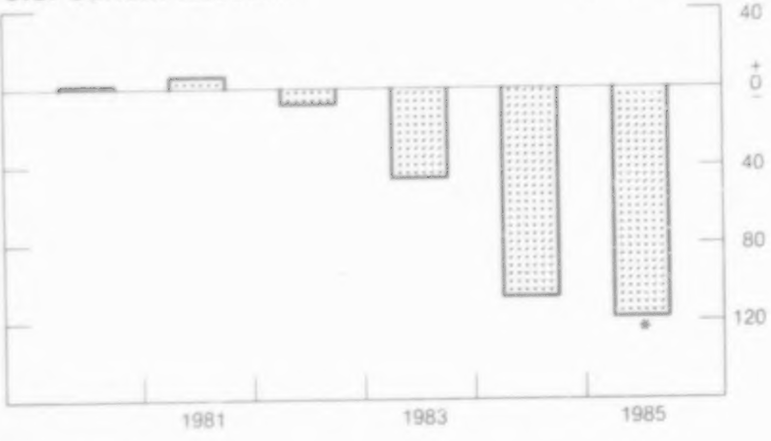
Exchange Value of the U.S. Dollar



U.S. Real Merchandise Trade



U.S. Current Account



* —Estimated.

Merchandise imports continued to rise in 1985, increasing about 3-1/2 percent in real terms over the year. Consumer goods, capital equipment, and industrial materials posted moderate increases. Although prices of imported goods fell for the year as a whole, some firming in the prices of manufactured imports became apparent toward the end of the year, in part attributable to the decline in the value of the dollar.

The volume of merchandise exports declined in 1985; agricultural exports fell abruptly, while exports of nonagricultural goods were essentially unchanged. The failure of growth in other industrial countries, on average, to pick up has limited the expansion of markets for U.S. products. Furthermore, economic growth in developing nations slowed a bit in 1985, as many countries continued to face difficult debt-servicing problems externally and strong inflationary pressures at home.

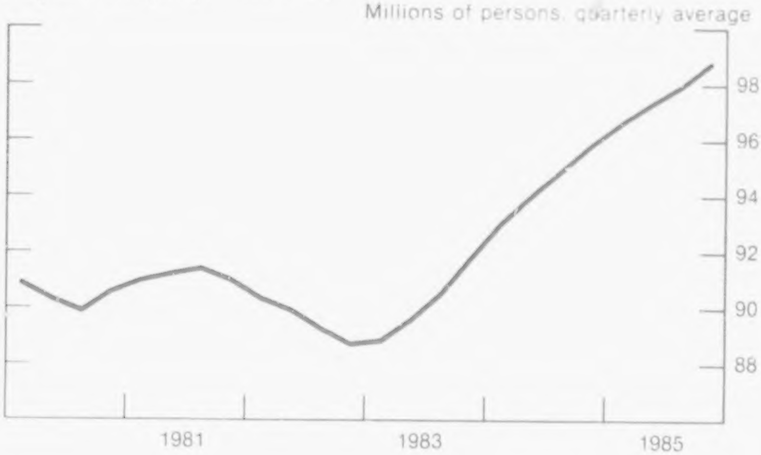
In this context, the Secretary of the Treasury in October addressed the economic and financial problems confronted by many of these countries. He urged the borrowing countries to undertake comprehensive programs of economic adjustment designed to promote efficiency and economic growth. At the same time, he called upon the international banking community, the World Bank and the other multilateral development banks, working with the International Monetary Fund, to provide the assurance that adequate external financing would be available to support such programs during the next several years. The initial response to these proposals has been positive; all parties generally accept that they represent a constructive framework for dealing with individual countries' international debt problems and for promoting the growth and stability of the world economy.

Labor Markets

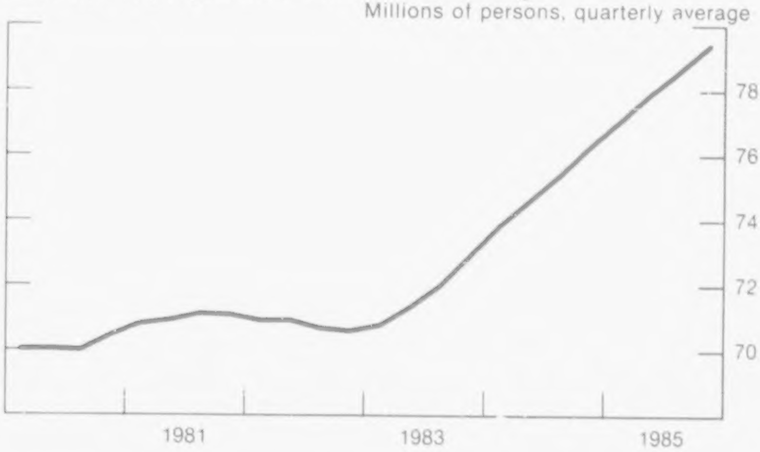
With the economy continuing to expand, developments in labor markets remained generally favorable in 1985. The unemployment rate drifted down over the year, as gains in employment exceeded the growth of the labor force. Labor force participation has maintained its upward trend; women continued to enter the workforce in large numbers, in part responding to expanding job opportunities. Overall, the number of persons employed relative to the population rose to a record level.

Nonfarm payrolls expanded 3 million in 1985, somewhat below the unprecedented hiring rate posted during the first two years of the recovery. Although growth in employment in the aggregate continued, the composition of the gains reflected the unevenness of current expansion. Employment in the trade and service sectors accounted for more than two-thirds of the growth in payrolls last year. Government employment rose nearly one-half million, reflecting primarily increased payrolls of state and local governments. In contrast, the weak expansion of output in the manufacturing sector resulted in some trimming of employment over the first three quarters of the year. Although an upturn in manufacturing jobs began in the fall, employment was down about 170,000 over the year.

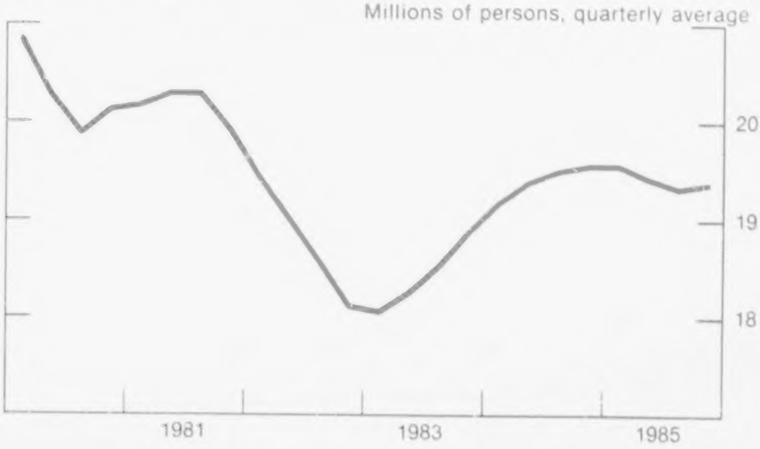
Wage increases remained restrained in most segments of the labor market last year, despite a further reduction in the unemployment rate. Hourly compensation in the private sector, as measured by the employment cost index, rose about 4 percent in 1985, one percentage point less than in the preceding year. Nearly all of the deceleration of compensation per hour last year reflected a slowing in the growth of fringe benefits; wage



Payroll Employment-Total

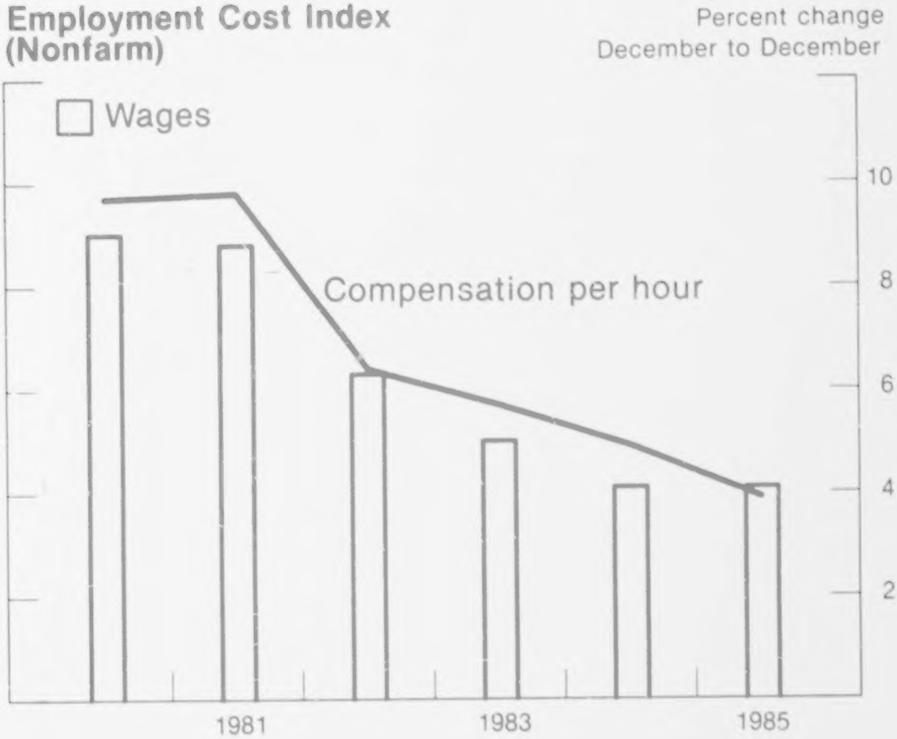


Payroll Employment-Nonmanufacturing

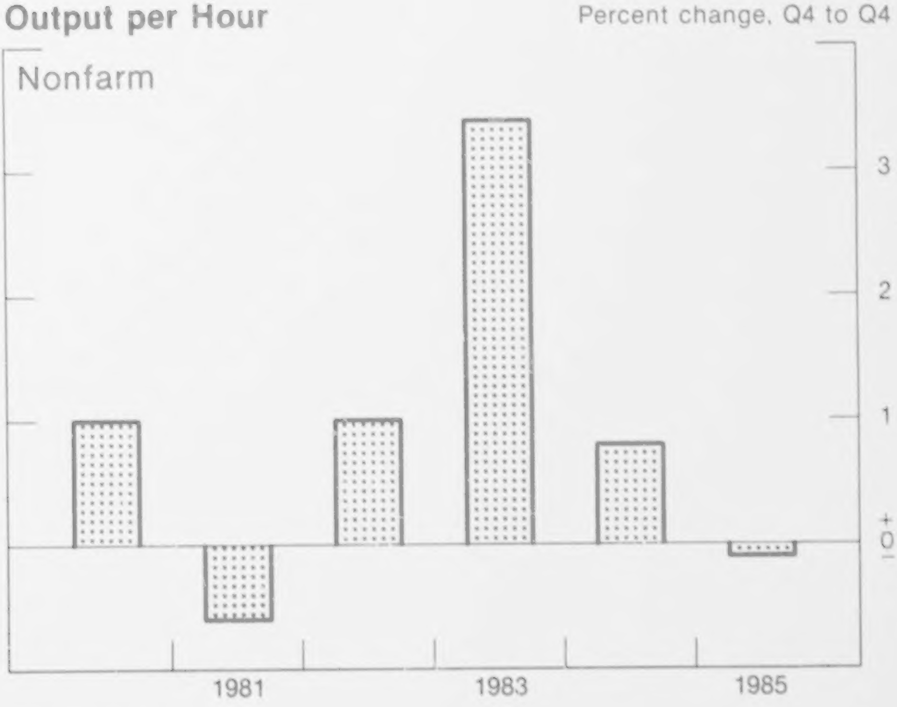


Payroll Employment-Manufacturing

Employment Cost Index (Nonfarm)



Output per Hour



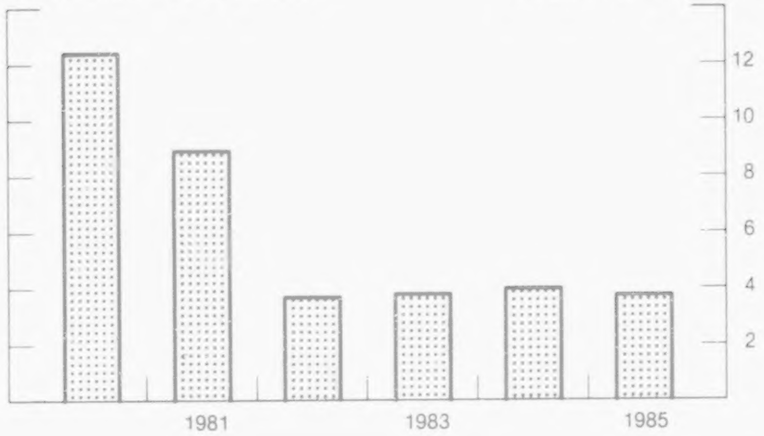
rates increased at about the same pace posted in 1984. To a large extent, the recent slowing in the growth of benefits has resulted from lower health care expenses for employers, as cost-sharing arrangements shifted greater responsibilities to employees and hospital cost containment programs became more widespread.

Meanwhile, labor productivity was nearly unchanged in 1985, after increasing substantially earlier in the recovery. When viewed over a longer period, the underlying trend in productivity in recent years appears to have improved a little from the very low pace of the 1970s, but remains well below the pace earlier in the postwar period. Management and workers have responded to a more competitive environment by modernizing plant and equipment, improving operational efficiency, and making work rules more flexible. Unit labor costs in the nonfarm business sector rose 3-3/4 percent in 1985, higher than the increase during the previous two years but well under the pace registered in the early 1980s.

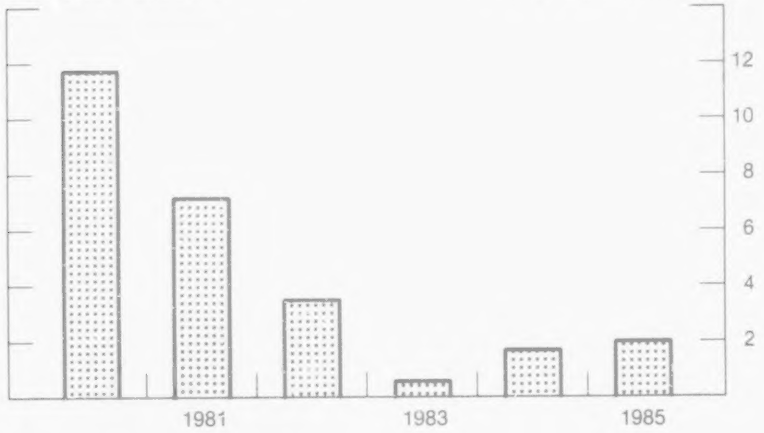
Price Developments

Most broad measures of prices indicate that inflation was unchanged or perhaps moved a bit lower in 1985, even as the economy was passing through a third year of expanding activity. The consumer price index advanced 3-3/4 percent over 1985, somewhat less than the 4 percent increase posted the previous year. The GNP fixed-weighted price index, which includes production for businesses, government, and export, as well as for consumers, increased 3-1/2 percent, about 1/2 percentage point less than the average increase over the preceding two years. Producer prices of finished goods

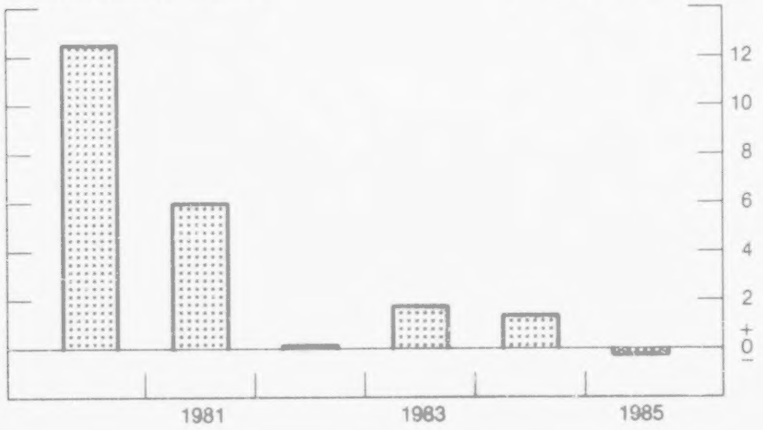
Consumer Price Index



**Producer Price Index
Finished Goods**



**Producer Price Index
Intermediate Goods**



advanced 1-3/4 percent last year and prices of intermediate materials were essentially flat.

Progress toward price stability has been sustained by several factors, the most important of which have been subdued inflation expectations, moderate wage increases, and the influence of the high value of the dollar on the prices of imports and goods that compete with imports. In addition, developments in the food and energy markets continued to restrain the overall rate of inflation in 1985. Energy prices showed little change last year; however, a substantial margin of unutilized productive capacity, continued conservation efforts, and the debt-servicing problems of several important oil producers have all contributed to a situation of surplus availability of oil and to a sharp break in oil prices on world markets at the end of the year. Crop prices at the farm have remained depressed by diminished export demand and high levels of production. Lower prices for crude foods and small increases in processing costs held food prices at the retail level to a 2-3/4 percent increase last year.

Prices for many basic industrial commodities fell during 1985. Weak expansion of industrial production in the United States and in other major industrial countries has limited the growth in demand for raw and semi-processed materials. Furthermore, the high prices for many raw commodities that prevailed over the 1970s and early 1980s induced a rapid expansion of capacity, particularly in developing countries. With productive capacity in place and with many of these countries facing massive debt-servicing requirements, supplies of commodities on world markets have remained plentiful.

On balance, price increases outside of the food and energy area held steady last year. Consumer prices other than food and energy increased about 4-1/2 percent, a bit less than in 1984. The prices of retail goods excluding food and energy were held to a 2 percent gain in 1985, at least in part by small increases or declines in the prices of products in markets where import competition is substantial. Price increases for nonenergy services remained at about a 5-3/4 percent annual rate last year. Capital equipment prices rose 2-3/4 percent in 1985, somewhat more than in 1984.

Section 3: Monetary Policy and Financial Markets in 1985

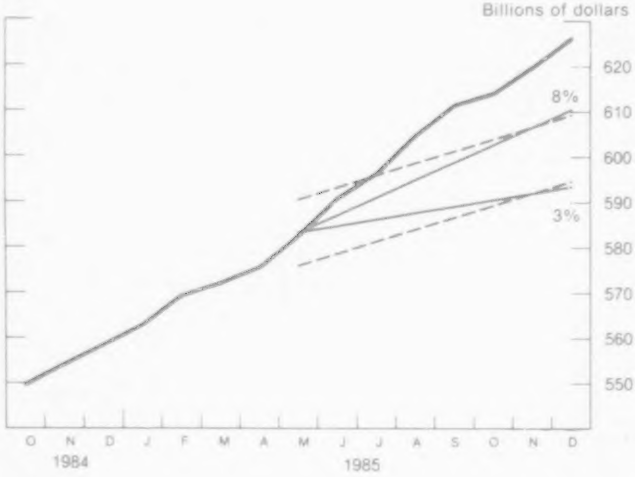
At its meeting in February 1985, the Federal Open Market Committee established ranges for money and credit growth during the year, measured from the fourth quarter of 1984 to the fourth quarter of 1985, of 4 to 7 percent for M1, 6 to 9 percent for M2, and 6 to 9-1/2 percent for M3. The associated monitoring range for the debt of domestic nonfinancial sectors was set at 9 to 12 percent.

In July, the Committee reaffirmed the ranges for M2, M3, and debt, but established a new M1 growth range of 3 to 8 percent, measured at an annual rate, from the second to the fourth quarter of the year. Over the first half of the year, M1 had grown well above the upper end of its range and velocity had registered an unusually steep decline, apparently reflecting substantial additions to money balances, especially interest-earning transaction balances, spurred by the sharp drop in interest rates since mid-1984. The M1 objective for the second half of the year anticipated a considerable slowing of growth, on the assumption that historically more normal behavior in the velocity of M1 would re-emerge. Continued uncertainty about the behavior of the aggregate, however, was signaled in widening the M1 range by 2 percentage points.

The unusual pattern of M1 behavior in fact persisted over the second half of the year; growth in the aggregate did not slow, and its velocity registered an even steeper decline. At the same time, the broader monetary aggregates were growing generally within their ranges, while economic growth had slowed to well below the pace of the year before and

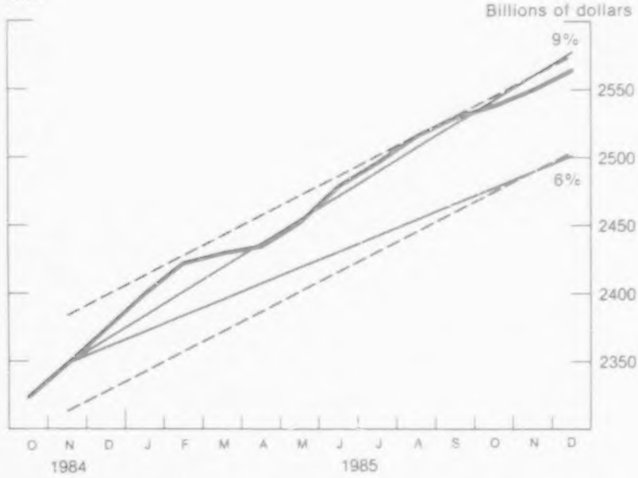
Ranges and Actual Money Growth

M1



Annual Rate of Growth
1985 Q2 to 1985 Q4
12.7 Percent

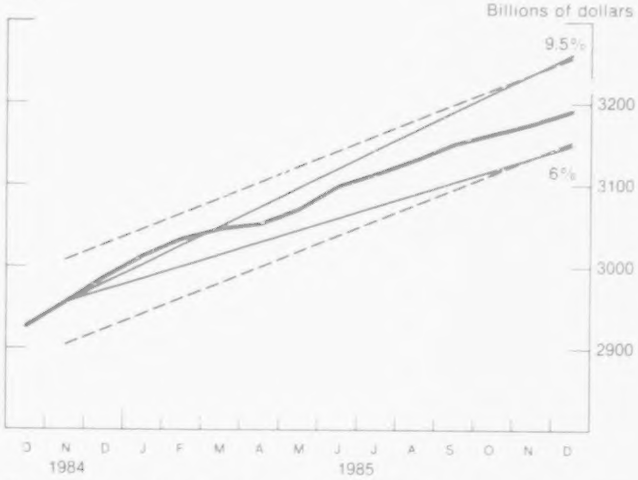
M2



Rate of Growth
1984 Q4 to 1985 Q4
8.6 Percent

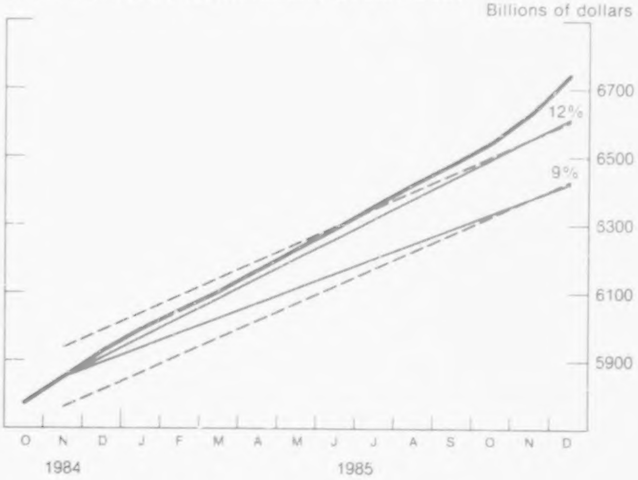
Ranges and Actual Money and Credit Growth

M3



Rate of Growth
1984 Q4 to 1985 Q4
7.4 Percent

Total Domestic Nonfinancial Sector Debt



Rate of Growth
1984 Q4 to 1985 Q4
13.5 Percent

upward price pressures remained muted. In the fall, the FOMC determined that, under these circumstances, growth in M1 above its range for the second half of the year would be acceptable.

In general, the FOMC last year emphasized the need to evaluate growth in all the aggregates in light of developments in the economy and prices, as well as conditions in financial and foreign exchange markets. Throughout the year, monetary policy remained generally accommodative to emerging demands for money. Pressures on bank reserve positions were varied in a narrow range over the year, and the discount rate was reduced once, by one-half percentage point.

Money, Credit, and Monetary Policy

M1 increased at a 12.7 percent annual rate from the second to the fourth quarter of the year, compared to its range of 3 to 8 percent for this period; growth for the year as a whole came to 11.9 percent. Much of the unusually strong growth in M1 in 1985 and the accompanying decline in velocity seemed to be attributable to lower interest rates, though expansion in the aggregate was stronger, particularly in the second half of the year, than historical evidence on its relationship to income and interest rates would have suggested.[1] The behavior of this aggregate may have become more sensitive to changes in market rates in recent years owing to the deregulation of certain transaction accounts. By reducing the opportunity cost of holding transaction balances, the creation of NOW and Super NOW accounts has made M1

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[1] Appendix A reviews the behavior of velocity in recent years.

GROWTH OF MONEY AND CREDIT[1]

Percentage changes

	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter to fourth quarter				
1979	7.5	8.1	10.3	12.4
1980	7.3	9.0	9.6	9.6
1981	5.2 (2.5)[2]	9.3	12.3	9.8
1982	8.7	9.1	10.0	9.1
1983	10.4	12.2	9.9	11.2
1984	5.4	8.0	10.5	14.1
1985	11.9 (12.7)[3]	8.6	7.4	13.5
Quarterly growth rates				
1985-Q1	10.1	11.7	10.1	13.5
Q2	10.5	6.3	5.6	11.9
Q3	14.5	9.5	7.6	12.2
Q4	10.6	5.9	5.7	13.7

---

1. M1, M2, and M3 incorporate effects of benchmark and seasonal adjustment revisions made in February 1986.
2. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.
3. M1 figure in parentheses is the annualized growth rate from the second to the fourth quarter of 1985.

a much more attractive savings vehicle for households. Moreover, with the rates on NOW accounts fixed and those on Super NOWs being adjusted sluggishly to changing conditions, falling interest rates have led to relatively substantial reductions in incentives to economize on M1 balances, with accompanying declines in velocity. However, considerable uncertainty about the response of M1 to variations in interest rates or income unavoidably persists, as both money holders and depository institutions adapt to the elimination of important regulatory constraints.[1]

In 1985, the interaction of lower market interest rates with deregulated transaction deposit rates seemed to induce especially heavy inflows to interest-bearing checkable accounts. Spreads between offering rates on these deposits and interest rates on time deposits and market instruments, low by the standards of recent decades, apparently diminished the incentives to keep savings in longer-term instruments, as well as to separate savings from transaction balances. Demand deposits also contributed to the increase in M1 last year, registering unusually rapid growth, especially in the second half. Business demand balances paced the rise, likely reflecting the cumulative effect of lower interest rates on incentives to economize on demand deposits and on compensating balance requirements, as well as generally more cautious cash management practices, possibly in part because banks and corporations sought to reduce risk in response to financial problems that had developed in certain areas of the market.

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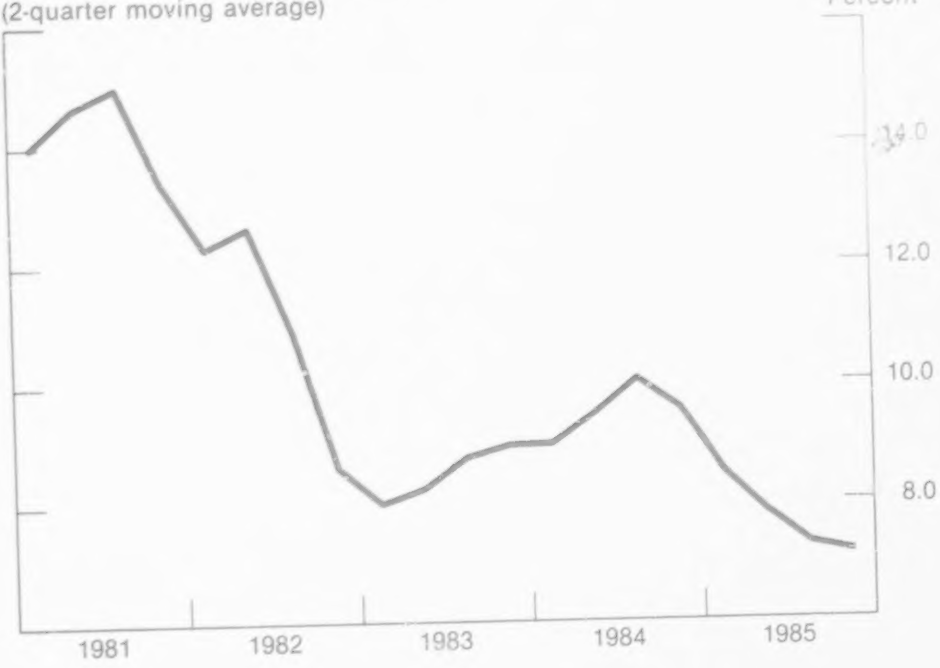
[1] Experimental alternative measures of money, which attempt to allow for the varying degree of "moneyness" in components of the monetary aggregates, are discussed in Appendix B.

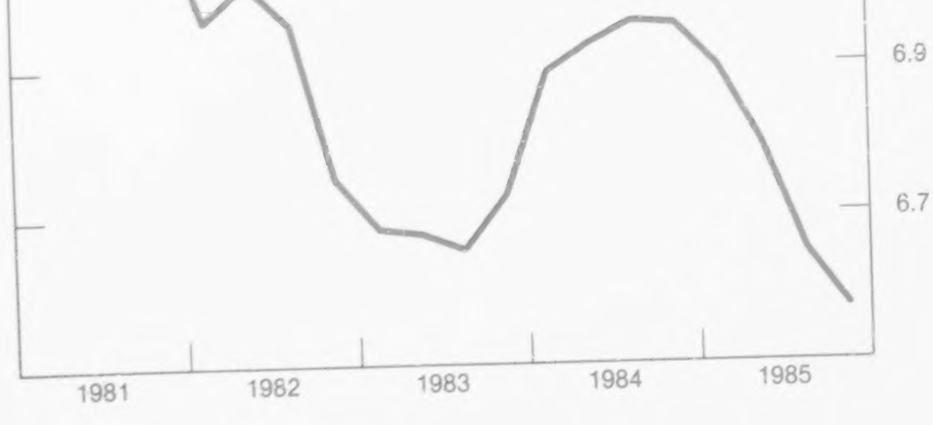
Treasury Bill Rate and Velocity of M1

3-month Treasury Bill Rate

(2-quarter moving average)



M1 Velocity



M2 recorded growth of 8.6 percent in 1985, in the upper part of its range, as its nontransaction component increased 7.6 percent. The shift toward more liquid assets evident in the rapid rise of M1 also affected the distribution of deposits within the nontransaction portion of M2. Small time deposits declined last year, while some very liquid components, such as money market deposit accounts, posted very large increases, and even savings deposits rose, by 4 percent, after several years of declines. However, growth of M2 appears to have been restrained to an extent by some redirection of household portfolios toward such non-M2 instruments as shares in stock and bond mutual funds.

M3 growth slowed to 7.4 percent last year--close to the midpoint of its range--reflecting in part a slower pace of credit expansion at depository institutions and consequently a reduced need to raise funds through managed liability issuance. Thrift institutions, in particular, greatly reduced their net acquisition of assets, partly in response to new Federal Home Loan Bank Board regulations that raised capital requirements for rapidly growing thrifts. The growth of large time deposits issued by thrift institutions slowed to less than 7 percent in 1985, down sharply from the nearly 50 percent pace recorded in the preceding year.

Expansion in debt of domestic nonfinancial sectors moderated only a little from its elevated 1984 pace and, at 13.5 percent, exceeded its 9 to 12 percent monitoring range. Last year was the fourth consecutive year in which debt expanded more rapidly than GNP, after more than 20 years in which the ratio of debt to GNP had been generally stable. One factor boosting debt growth relative to spending has been the extraordinary pace of corporate borrowing to retire equity in mergers, buyouts, and stock repurchases. The volume of such borrowing appears to have been as large in 1985 as in 1984. In addition, borrowing surged late last year in the tax-exempt market, where issuance was accelerated in anticipation of possible tax law changes. Even after allowance for these two factors, which together may have accounted for roughly two percentage points of debt growth in 1985, the expansion of the debt of domestic nonfinancial sectors remained very strong. An important element in the continued rapid growth of debt and the rise in its ratio to GNP has been the huge size of federal deficits. Although federal debt growth has slowed since 1982, it continued to run at over 15 percent last year.

In implementing policy during 1985, the Federal Reserve basically accommodated the strong demands for reserves by depository institutions. In the early part of the year--when M1 expansion was very rapid, and M2 and M3 growth was also strong--interest rates backed up somewhat. However, these increases were more than reversed later in the first half, influenced in part by a half percentage point cut in the discount rate from 8 to 7-1/2 percent in May, as economic activity appeared more sluggish, partly reflecting the drag from the relatively high value of the dollar on exchange markets. Growth of the broader aggregates had slowed appreciably after the early part of the year, though M1 remained well above its range. On balance over the first six months of the year, most market interest rates fell about one percentage point, leaving them about 3 to 4 percentage points below their mid-1984 levels. On exchange markets, the dollar, which had risen sharply through February, declined thereafter and by midyear was 9 percent below its

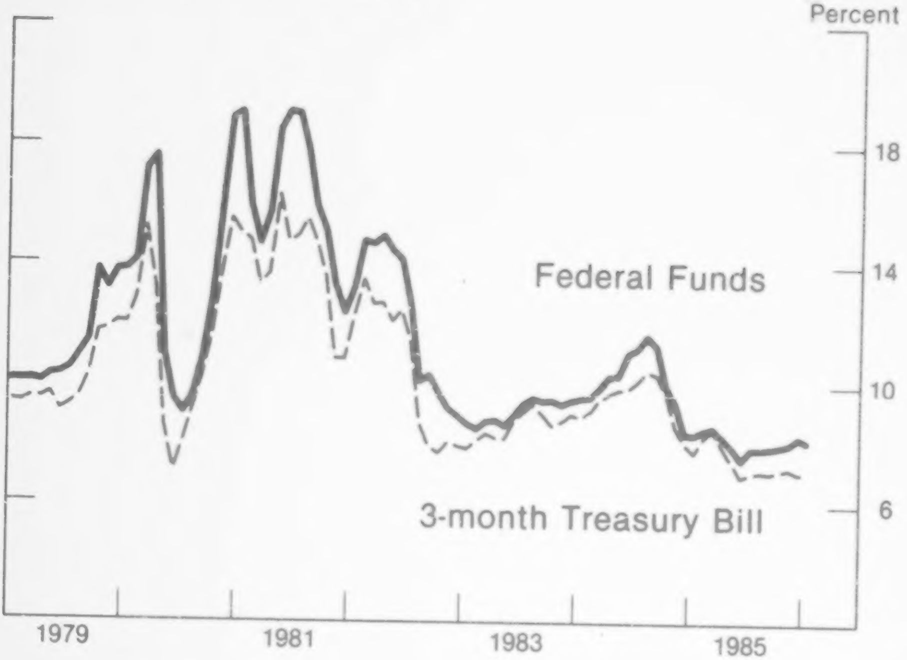
February peak on a trade-weighted basis, leaving it just under its level at the end of 1984.

When, at its July meeting, the FOMC reaffirmed its ranges for M2, M3 and debt, and widened and rebased the M1 range, the members anticipated that these ranges would be consistent with continued subdued inflation and some pickup in economic growth from the sluggish first-half pace. As the summer progressed, however, it became clear that the demand for M1 remained strong. After slowing somewhat in July, M1 spurted again in August and continued to rise at a double-digit annual rate in September. M2 growth also picked up during the summer, climbing above its range in this period.

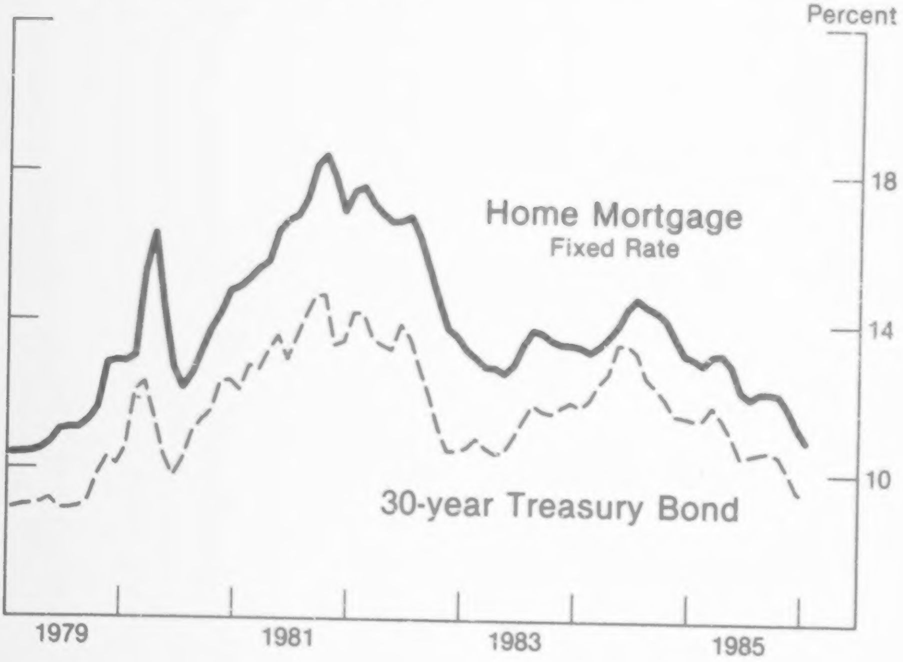
In the summer, market interest rates reversed a portion of their earlier declines. With both M1 and M2 growing relatively rapidly, economic activity apparently picking up, and the dollar having declined further, the Federal Reserve provided reserves a bit more cautiously for a time. But beginning around mid-autumn, the Federal Reserve was seeking a slight easing in bank reserve conditions, as incoming data suggested that relatively moderate increases in economic activity continued to be in prospect and upward price pressures remained subdued. Meanwhile, M1 growth was continuing strong on balance, but growth in the broader aggregates was slowing.

On balance over the second half of the year, most short-term rates were little changed, ending the year just slightly above their midyear lows and about a percentage point below their levels when 1985 began. However, on exchange markets, the dollar declined more than 15 percent over the second half, impelled in large part by the G-5 announcement in September indicating the desirability of some appreciation of other currencies relative to the

Short-term Interest Rates



Long-term Interest Rates



dollar and by the ensuing coordinated intervention by the United States and other key industrial countries.

In long-term debt markets, interest rates generally fell a percentage point or more on balance over the second half, with most of the decline occurring during a fourth-quarter rally that accelerated as the year drew to a close. The downward movement in long-term rates, and simultaneous surge in stock market prices, was fueled in part by legislative initiatives to mandate reductions in the federal deficit and pare the government's demands on credit markets. Declining world oil prices and the continued softness in markets for other commodities promoted expectations of lower inflation among market participants, also contributing to the rally.

Other Developments in Financial Markets

Corporations were able to reduce their demands on credit markets in 1985 as strengthening profits and weaker capital expenditures narrowed the sector's financing gap. Nevertheless, business borrowing to finance stock retirements remained high--perhaps $70 billion in each of the last two years. Spurred by the drop in long-term rates, to six-year lows, corporate credit demands focused on the bond markets. Record amounts of securities were offered publicly by nonfinancial firms in both the domestic and the Eurobond markets last year. On the other hand, short-term borrowing slowed, with bank lending to businesses relatively weak.

Tax-exempt borrowing was extraordinarily strong last year; a surge in bond offerings late in the year lifted 1985 volume to a record high. While more favorable interest rates stimulated borrowing generally, efforts to finance in advance of possible restrictions under a proposed tax law scheduled to take effect after year-end boosted advance refunding and private purpose issues in particular.

Households continued to borrow heavily in 1985. Their debt-servicing burden rose sharply as they continued to add to debt at a double-digit rate at the same time that disposable income growth slowed. Signs of potential strain appeared, as the delinquency rate for consumer installment loans rose, although most measures of debt quality remained well within past experience. Consumer credit remained especially strong, growing at nearly the 20 percent rate recorded in 1984. But the growth of home mortgage borrowing, while near its 1983-84 average, was probably restrained somewhat by the tightening of lending standards that accompanied the rise of mortgage loan delinquency rates to record levels.

Strains were evident in financial markets at times in 1985, but did not cause major disruptions in overall market conditions. Financial market concern over credit quality issues was not severe enough to be reflected in a broad-based widening of yield spreads between corporate and Treasury debt, or between private-sector securities of different risk classes. Nevertheless, the agricultural sector of the economy continued to experience serious financial distress and there were pressures on some segments of the financial community at times last year.

Early in the year, privately insured savings and loans in Ohio and, then, in Maryland were closed or limited to small withdrawals after depositor runs in both states. The problem in Ohio was triggered by news of losses at one large thrift. Problems developed in Maryland when heightened depositor anxiety in the aftermath of the Ohio crisis combined with news of difficulties at a local savings and loan. As the difficulties emerged, the Federal Reserve advanced funds at the discount window to the affected institutions to bolster their liquidity. Such lending--whose expansive reserve effect was offset through open market operations--has been repaid in Ohio, where the troubled institutions have been restructured and reopened, but remains outstanding at a number of Maryland thrift institutions.

The thrift industry as a whole showed some improvement in earnings and capital positions last year, although many institutions remained heavily burdened with low quality or low yielding assets. Lower interest rates lifted profits from their depressed 1984 levels by reducing the cost of funds and generating capital gains on asset sales. The profitability of commercial banks also appears to have increased in 1985, breaking the downtrend of recent years. Asset quality remained a concern for some institutions, however, and was a major factor in the sharp increase in the number of bank failures. Banks apparently again increased the rates at which they charged off bad loans and added to loan-loss reserves, reflecting continued financial strains in such industries as agriculture, energy and real estate. Higher profits along with the rallies in stock and bond markets helped many banks improve their capital positions in 1985, facilitating efforts to comply with more stringent capital adequacy guidelines. As part of its efforts to ensure the continued safety and soundness of the financial system, the Federal Reserve also initiated a program to strengthen supervision of commercial banking operations.

Agricultural finances drew special attention last year. Farm income remained depressed, and falling prices for agricultural products left many farmers unable to meet their debt-servicing requirements. Moreover, declining land prices eroded the value of collateral behind many agricultural loans. Consequently, failures of banks with relatively high proportions of agricultural loans in their portfolios rose to 68 in 1985, from 32 in 1984 and an average of just 6 in each of the preceding three years. The Farm Credit System, which holds about one-third of U.S. agriculture's debt, experienced mounting losses and requested federal aid. Farm Credit securities, which had been priced very close to comparable maturity Treasury issues, yielded as much as 100 basis points more than Treasury debt at one point in the fall. Rate spreads narrowed in December, following passage of legislation enabling the Farm Credit System to mobilize its resources more readily and providing for the possibility of a backup source of assistance once internal sources of funds are exhausted.

To ease possible constraints on the availability of credit at agricultural banks over the 1985 growing season, the Federal Reserve in March liberalized its regular seasonal borrowing program and initiated a temporary special seasonal program aimed at making liquidity available to agricultural banks that might experience strong loan demand. Although total seasonal borrowing fell short of the unusually high level in 1984, evidence suggests that these actions increased access to seasonal credit, boosting borrowing somewhat above what would otherwise have been expected given money market conditions and overall slack loan demand by farmers. In early 1986, the Federal Reserve renewed the temporary seasonal program to assure that agricultural banks would not face liquidity constraints in accommodating the needs of their farm borrowers this year.

Appendix A: Velocities of the Monetary Aggregates in the 1980s

In 1985, the relationship between M1 and nominal GNP diverged substantially from historical patterns, as M1 velocity registered a sharp drop of 5-1/2 percent. In contrast to the increases that had doubled velocity over the course of the 1960s and 1970s, last year's decrease left M1 velocity about 8 percent below its 1981 peak level. Velocities of the broader monetary aggregates also declined in 1985, but these declines were not so far off their historical norms.

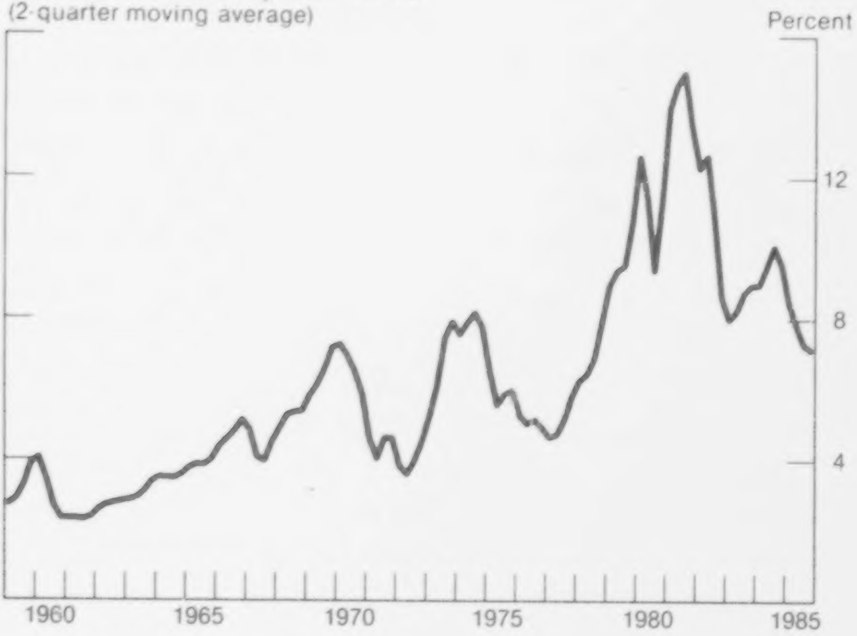
The downward trend of M1 velocity so far in the 1980s differs markedly from the 3-1/4 percent annual rate of increase averaged during the preceding two decades. Two developments in recent years appear especially pertinent to explaining the changed relationship between M1 and income. First, interest rates at the end of last year were substantially below their peak levels in 1981. With such a decline, the earnings forgone in holding money, with its liquidity advantage, were considerably reduced, and preferences for money relative to other financial assets would be expected to increase in response. As this occurred, the velocity of M1 would be expected to decline.

Second, deposit rate deregulation has changed the pricing behavior and yield comparisons between some M1 deposits and other deposits and financial instruments. Whereas earlier, only non-interest-bearing assets--demand deposits and currency--directly served transaction needs, in the 1980s individuals have had available for transaction purposes first NOW accounts with a 5-1/4 percent ceiling and subsequently Super NOW accounts with higher, competitively set rates.

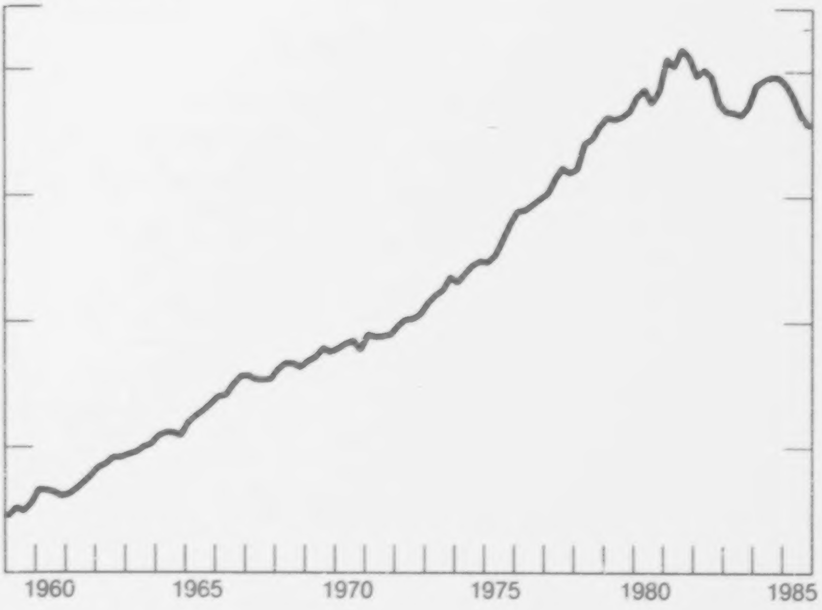
Chart A1

Treasury Bill Rate and Velocity of M1
Historical Perspective

3-month Treasury Bill Rate
(2-quarter moving average)



M1 Velocity



These institutional changes have reduced pressures for innovations that would enable depositors to conserve on M1 holdings or use them more intensively to support spending. Such innovations had contributed to the previous uptrend in M1 velocity. But also, the proliferation of interest-bearing checkable deposits for individuals, nonprofit organizations and governmental units has altered the balance of motives for holding M1 deposits, making them more attractive repositories for savings as well as transaction funds and probably increasing the sensitivity of M1 demand to changes in market interest rates. This effect has grown in importance as interest-bearing checkable deposits have grown. Such accounts have proven enormously popular; at the end of last year, almost $180 billion in interest-bearing checkable accounts was outstanding, including more than $60 billion in Super NOWs, which have been available for only three years. The total figure compares to outstanding balances of under $30 billion when NOW accounts were first authorized on a nationwide basis at the end of 1980. By the end of 1985 interest-bearing checkable deposits had reached about 30 percent of M1 and 40 percent of the deposit component of that aggregate.

The resulting higher interest rate sensitivity of the public's demand for M1 relates to the fact that when market rates decline, the opportunity cost--the gap between those rates and the fixed ceiling on NOWs--declines in percentage terms much more than do market rates themselves. And the tendency of offering rates on Super NOWs to lag market rate changes has made their opportunity costs also move like those on fixed-rate accounts in the short run. Recent trends toward depository institutions applying higher interest rates or lower fees to transaction accounts with higher balances have probably further changed opportunity cost calculations. This "tiering" can have the effect of providing a very high rate of return--and thus a low opportunity cost--on funds added to an account because, for example, per-check charges or other fees may cease to apply at the new larger balance.

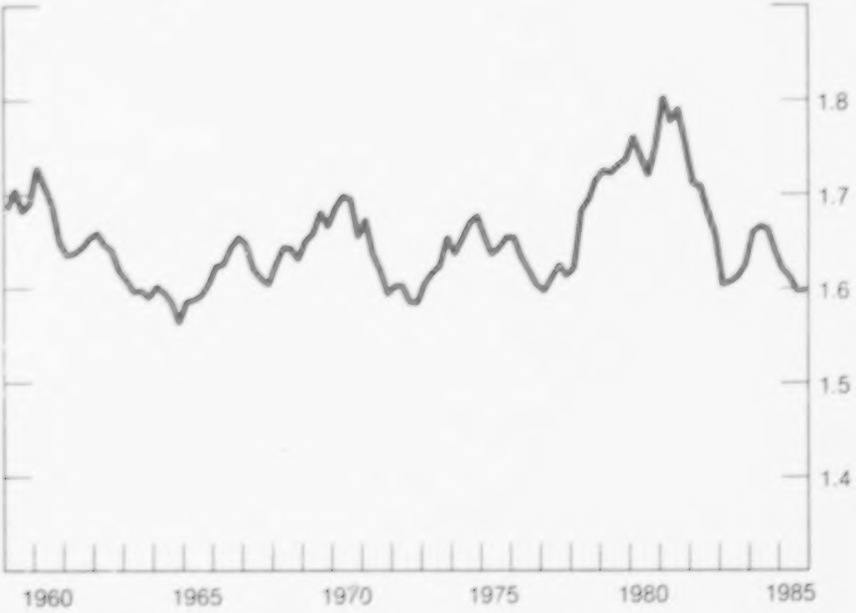
Not only does the responsiveness of M1 to interest rates and income seem to have changed in the 1980s, but the behavior of M1 also appears to have become less predictable on other grounds. In part, the increased unpredictability of M1 demand is due to the larger share of savings balances in M1, which has made general portfolio-balance considerations a more important influence. Over the past several years, deposit rate deregulation has given institutions vastly increased freedom to set deposit rates and has provided their customers with a larger menu of assets paying market-related rates. With regulations progressively changing and depositors and depository institutions continually adapting to the changes, uncertainty has increased concerning the impact on money demand of variations in economic and financial conditions, including changes in wealth of money holders. Moreover, since the process of deposit rate deregulation has occurred alongside a general decline in inflation and market interest rates, the reasons for and permanence of apparent shifts in M1 behavior often have been obscured.

The declines in the velocities of M2 and M3 last year were neither as large as in that of M1, nor were they as far from their longer-term trends. M2 velocity has declined in recent years, but on balance has shown little change over recent decades. While last year's drop in M2 velocity was about twice the average of the past several years, its size was within historical experience. The M3 velocity decline was somewhat smaller than in

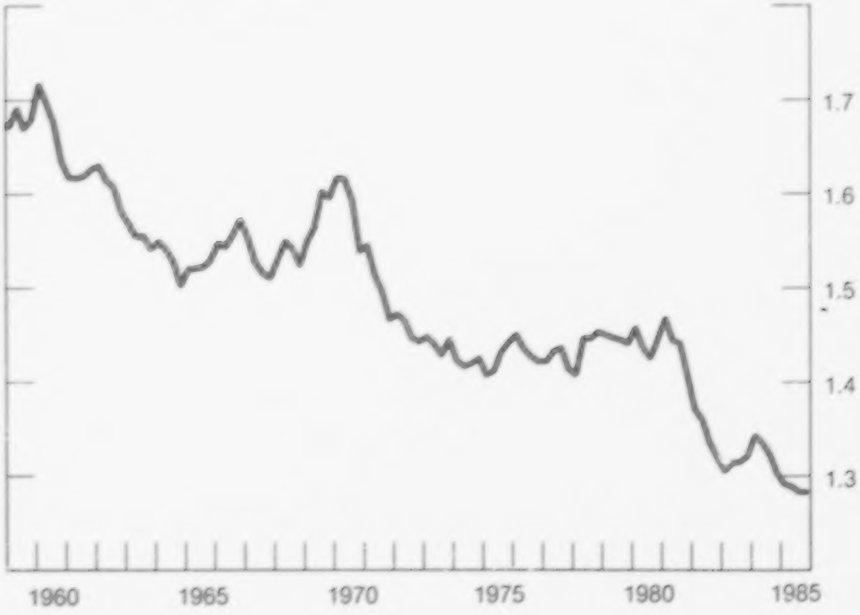
Chart A2

Velocities of M2 and M3
Historical Perspective

M2 Velocity



M3 Velocity



recent years and continued a long-term downtrend in that measure. Nevertheless, the behavior of the broader aggregates probably has been altered by developments in the 1980s. For example, the interest-rate responsiveness of M2 probably has declined with deregulation, which has permitted the yields on many of its components to vary with market rates. While this aggregate continues to show strong responses to rates over short periods, over intervals of a half-year or more it has been far less affected than M1.

Appendix B: Experimental Money Stock Indexes

Financial deregulation and innovation since the mid-1970s have blurred distinctions between transaction and nontransaction balances. As businesses and consumers have changed their payments practices and portfolios of financial assets, uncertainty about the behavior of conventional monetary aggregates and their ability to foreshadow movements in GNP has intensified. The narrow aggregate M1 has been affected most noticeably. This aggregate consists of currency, demand deposits, and checkable deposits paying interest, mainly NOW accounts. The share of M1 balances paying interest has grown substantially and is held partly for savings purposes. In 1982-83 and again in 1985, growth of M1 was unusually strong relative to GNP. Old M1-A, which includes only currency and demand deposits, was less affected in those years, but because it excludes NOWs, it understates transaction money. In 1981, M1-A was considerably distorted as demand deposits were shifted into newly authorized nationwide NOWs.

In light of these developments, the Board's staff has investigated several alternative measures of money. This appendix focuses mainly on the transaction money stock measure, MQ. Its components encompass currency and all checkable instruments that serve as means of payment, including money market deposit accounts (MMDAs) and certain money market funds, both of which have limited check-writing features. In contrast to the conventional aggregates, though, MQ is an index number. In general, index numbers are used to combine items that have dissimilar characteristics; an example would be the differing economic value of the various items in the industrial production index. In MQ, components are treated conceptually as differing in the volume of "GNP transactions" each finances per dollar, notwithstanding their common one dollar unit of account.

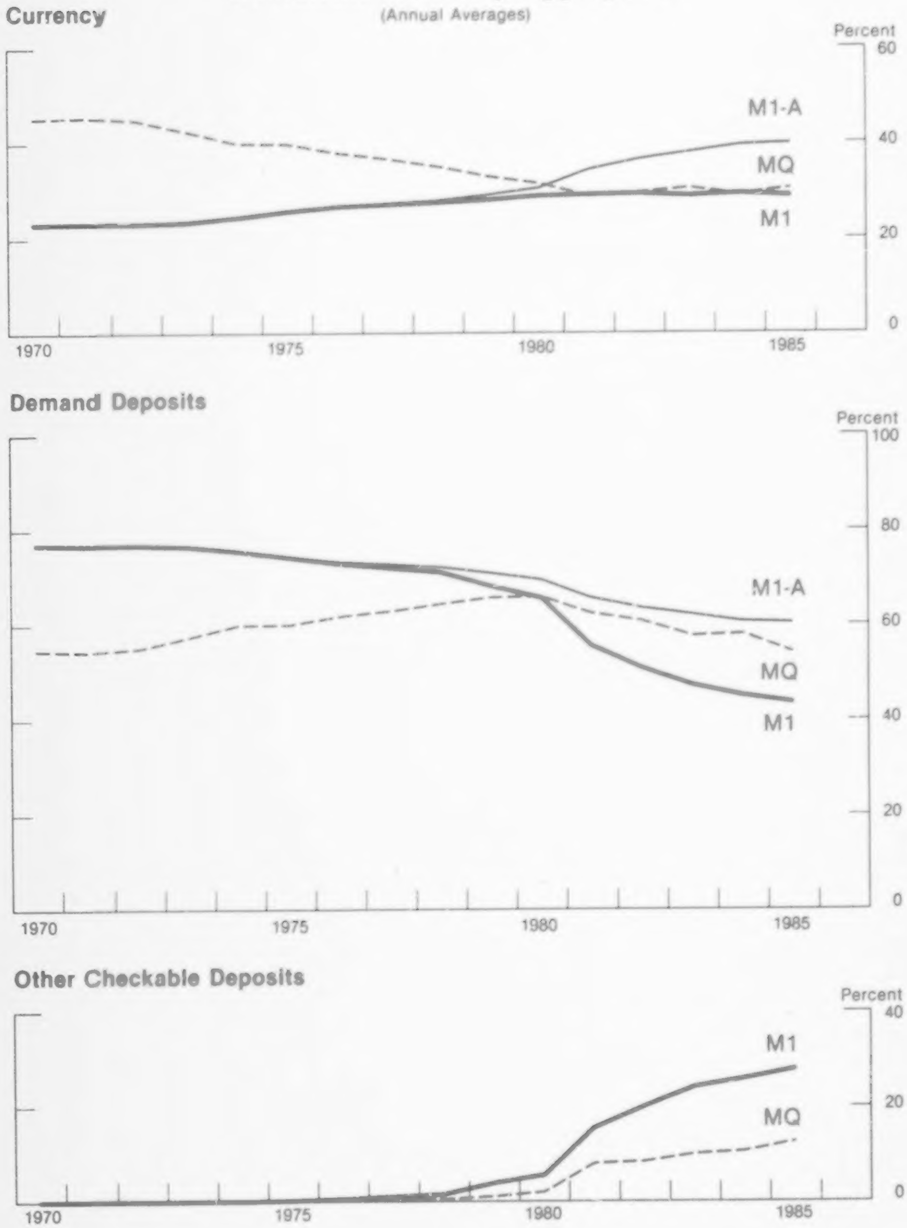
MQ and conventional narrow monetary aggregates are alike in that the growth rate of either can be thought of as a weighted average of the growth rates of its components. But the weights applied to the growth rates of components are not equal for these different monetary aggregates. In conventional M1 and M1-A, the implied weights are simply dollar shares of each component in the total. In MQ, the weights on the growth rates of components reflect not only differences in dollar amounts among components but also differences in the estimated intensity with which the various components are used in carrying out GNP transactions. Thus, instead of dollar quantity shares, MQ uses as weights the estimated share of GNP spending financed by each component.

Chart B1 shows the different weights applied to growth rates of selected components of M1, M1-A and MQ. The heavy solid line in the third panel of the chart, for example, shows that the implied quantity-share weight on the growth rate of other checkable deposits in M1 growth was about 26 percent in 1985, meaning that the 22 percent growth in this component last year contributed about 5-3/4 percentage points (26% x 22% = 5-3/4%) to the growth rate of M1. Because they are excluded from M1-A, these deposits receive a zero weight in M1-A growth. The weight on the growth of other checkable deposits in MQ growth, the dashed line, was about 12-1/2 percent in 1985, so the rapid growth in this component contributed only about 2-3/4 percentage points to MQ's growth rate over last year.

Chart B1

Weights on Growth Rates of Components in Narrow Monetary Aggregates

(Annual Averages)



When applied to the component growth rates, these weights produce the growth rates for MQ and the conventional narrow aggregates presented in the top panel of chart B2. MQ grew somewhat faster in the mid-1970s than M1. Over that period, demand deposit growth, which was relatively weak, received a lower weight in MQ, and currency growth a higher weight, than in M1. Since then, MQ growth has been between growth of M1-A and M1. Although, in principle, MQ tends to adjust automatically for changes in payments practices, the experience in 1981 with major shifts from demand deposits to nationwide NOWs exemplifies the practical difficulties in developing appropriate weighting procedures. Still, M1-A was even more distorted than MQ in 1981. Over 1985, MQ growth was about 1-3/4 percentage points slower than conventional M1 growth but around 2 percentage points faster than M1-A growth.

The bottom panel shows the growth rates for the broader conventional aggregates M2 and M3. In 1983, M2 growth was distorted upward by the introduction of MMDAs, but otherwise it has been rather steady since the late 1970s.

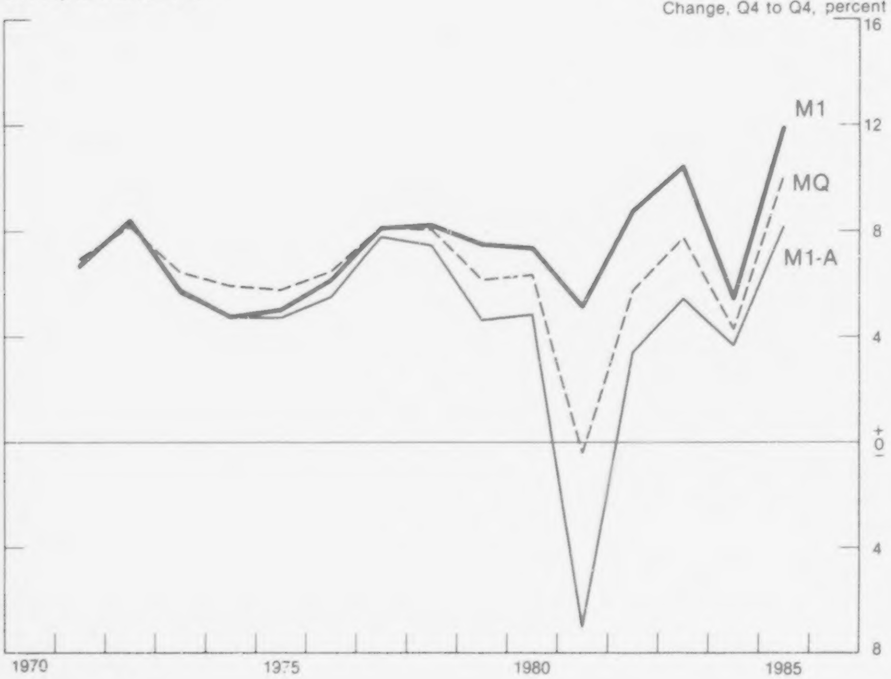
Annual velocity growth for MQ, shown in the top panel of chart B3, has been between the growth rates of V1 and V1-A since the late 1970s. Over 1985, as over 1982, all three velocities fell, with V1 registering the steepest declines in both years. Velocities of the broader conventional aggregates, in the bottom panel, declined at about the same rate as V1 in 1982 but by less than V1 in 1985.

The predictability of MQ's demand, given interest rate spreads and GNP, has been roughly comparable to that of M1 and M1-A demand on average over the 1980s, with all three narrow aggregates exhibiting unexpectedly

Chart B2

Growth Rates of Selected Monetary Aggregates

M1-A, M1 and MQ



M2 and M3

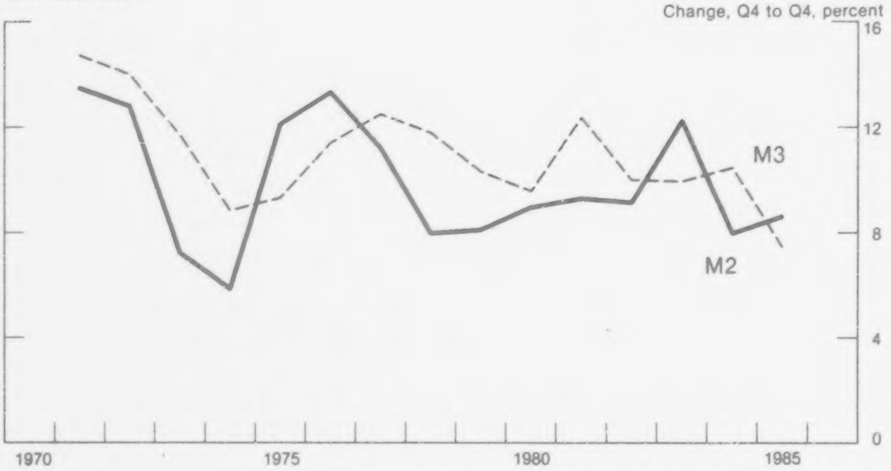
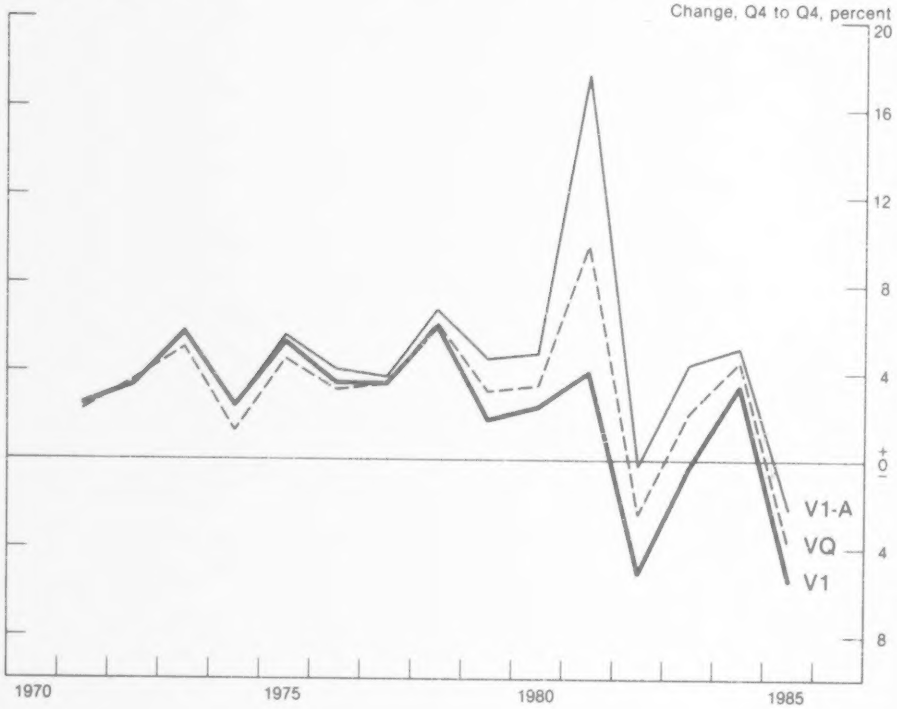


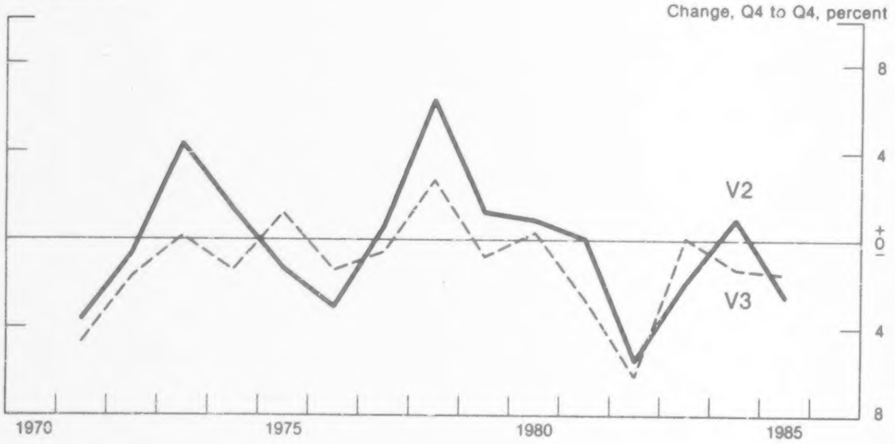
Chart B3

Growth Rates of Velocities of Selected Monetary Aggregates

V1-A, V1 and VQ



V2 and V3



large increases in 1985 relative to econometric predictions. In 1982-83, however, MQ's demand was more predictable than either M1 or M1-A. None of the three has been appreciably superior in its ability to presage movements in nominal GNP so far in the 1980s, on the basis of statistical relations that held on average over the 1970s; each signaled considerably more nominal GNP growth than actually occurred in 1982-83 and again in 1985. The broader conventional measures performed better than MQ, as well as conventional narrow measures, in these relatively simple tests of their demand and indicator properties for the 1980s, but they were less reliable indicators of GNP in the prior decade.

Research is continuing on the development of MQ and the assessment of its demand and indicator properties. Efforts are under way to refine the procedures used to estimate MQ's weights, as well as to improve the basic method of weighting major outflows from particular accounts, such as those distorting MQ in 1981. At this time, however, understanding the significance of movements in MQ is hampered not only by limited experience with the aggregate but also by unresolved conceptual and measurement questions.

In addition to MQ, several other monetary indexes have been constructed experimentally. The transaction money stock index MT is similar in concept to MQ but focuses on the way money is used for all transactions, including payments associated with financial trading, intermediate output and so forth, instead of just GNP spending. In a different approach to monetary indexes, the monetary services indexes have been constructed to reflect a broader view of money as providing a range of services, such as liquidity, beyond means of payment, and correspondingly encompass broader collections of component assets; such indexes distinguish components by the estimated opportunity cost of holding each monetary asset rather than investing in the highest-yielding alternative financial asset. As with MQ, conceptual and measurement problems remain to be solved for these other experimental indexes, which thus far do not appear to perform as well as conventional aggregates.

The CHAIRMAN. Thank you, Chairman Volcker. I think that everybody will agree that you have certainly given us a very broad overview, not a full platter but a buffet.

In your presentation you mentioned declining oil prices quite a few times. You also mentioned that in many of our financial institutions, as a result of very aggressive lending over a period of time and as a result of changes that are now occurring that, as we all recognize, because there has been a higher frequency of bank failures occurring in the Nation.

Then again, I note that, under Gramm-Rudman, there will be an adverse effect on the operations of the supervisory and regulatory agencies, and at this point we will not even mention the FSLIC, but just stick with the FDIC, commercial institutions, and mutuals. So that means the Comptroller's Office and the FDIC are being affected adversely by Gramm-Rudman. They are going to see a reduction in their funding.

I understand that the Fed on a voluntary basis is also going to cut back to an amount similar to Gramm-Rudman, although they are not required to.

That means, unless I am terribly mistaken, that the personnel available in this era of troubled financial institutions, will be substantially reduced. However, during hearings on "Deposit Insurance Reform," we were told about the problems they would incur with a lack of personnel.

Now you look at the oil price situation, and the fact that many banks will be adversely affected. John Q and Jane Q citizens say to themselves that they are not too sympathetic. We have to recognize that this decline in oil prices will affect banks that have lent substantial sums to oil-producing companies.

So my question at this point is, if as you state in your presentation, we have a mounting problem in many financial institutions and if we're going to reduce the amount of personnel available to us to supervise and regulate these institutions, isn't there a contradiction? Is it fair to conclude that it doesn't make too much sense at this point to reduce the number of personnel we have working on the problem financial institutions of this country when the number of problem institutions is at an all-time high.

Mr. VOLCKER. Yes, I think there is a potential contradiction there, Mr. Chairman.

I can only speak directly for the Federal Reserve. We are increasing and will continue to increase the number of our supervisory personnel, and we will make every effort to do that within the context of responding to the spirit of Gramm-Rudman, which means greater cuts elsewhere. We have planned a sizable increase for supervision.

I cannot tell you that the size of the planned increase will not be affected. I think it will be affected at the margin, but we are still going to have a significant increase in supervisory resources. I can't speak to the other agencies, they are——

The CHAIRMAN. They don't have the flexibility——

Mr. VOLCKER. That's right, and precisely the point I was going to make, that the Comptroller and the FDIC may have some flexibility between the liquidation and the examination function, but they don't have the same degree of flexibility that we do because they don't have as many functions.

I think the Federal Home Loan Bank Board and the home loan banks do have some flexibility, fortunately, because that is an area where the need has been, if I may say so, particularly acute. It's been a matter of great priority for Mr. Gray and his colleagues, and my understanding is that that effort can continue substantially within the confines of Gramm-Rudman, because much of that is done out in the Federal home loan banks, but there is no doubt that it creates problems for the Federal Home Loan Bank Board and the FSLIC as you suggested.

The CHAIRMAN. You briefly mentioned the study of the off balance sheet problem. Many people might scratch their head, and ask what's he so concerned about that for. In essence, what that means is that many financial institutions have off balance sheet items that don't really appear in their accounting and when these institutions suddenly find themselves with big problems, we find the situation is far more acute than had been perceived.

I understand that the Fed is doing a study on this. Is it being done in conjunction with the FDIC and the Comptroller of the Currency?

Mr. VOLCKER. We have had several studies going on. We have engaged in one study on an international basis, because this is not just a problem of U.S. banks. It's been done within the context of the BIS, and I think that's going to be published, if I understand correctly, fairly shortly, and it's a rather comprehensive international look at the problem. But I'm sure that the other regulatory agencies have, from their own perspectives, looked at this problem too. It is of concern to all the supervisory agencies and I think all of us are bringing it in to our analysis.

All the agencies are looking at this adjusted capital ratio approach. One of the premises of that approach is that we do want to make allowance for those so-called off balance sheet risks in establishing capital standards, and the thinking of all the agencies is uniform in concept.

The CHAIRMAN. Thank you, Mr. Chairman.

Mr. Gonzalez.

Mr. GONZALEZ. Thank you, Mr. Chairman.

The most significant domestic economic event is the rapid fall in oil prices. Lower oil prices clearly will help reduce inflationary pressures and spur economic growth, but the dark side is that falling oil prices also mean big trouble for domestic banks with large energy loan portfolios and also problems for money center banks that have vast foreign loans to energy exporting countries that find themselves unable to pay because of the reduced oil prices.

There are some who say we need an oil import fee to stabilize domestic prices and preserve the U.S. energy industry. They also argue that an oil import fee will alleviate the Federal deficit and encourage conservation.

Do you feel an oil import fee is needed or would be beneficial?

Mr. VOLCKER. You're getting a little bit outside my area for me to make very precise comments. But I've thought about it a bit. Let me say that I would approach that largely as a conservation measure. If it were deemed needed because the oil price had gotten so low that there was damage in retracing some of the very useful steps toward energy conservation and relative independence that have been made with great effort over the past decade, and if it created a situation in which we are in greater risk of a sharp increase in the oil price down the road, I think that would be the basic rationale and that's what you would have to look at.

As a revenue raising measure, I don't think it's all that effective. It's hard for me to see that we could reasonably put on a tax or tariff at the border on our energy without exempting some of our neighbors who are very heavily dependent on exporting oil to the United States. Once you do that, you don't have all that much left to tax; you get a big price impact internally for relatively little revenue. And, of course, any tax of that sort does offset some of the beneficial effects that you mentioned from the lower price.

So I wouldn't be very eager to do that, but I understand, depending upon where the price went, that's something that could be looked at. But I would not in any sense be pushing it or supporting it at this point.

Mr. GONZALEZ. Since the falling oil prices clearly jeopardize the integrity of major banking institutions that have lent billions of dollars to oil exporting countries that are now clearly unable to pay, and you have mentioned some, what steps has the Federal Reserve taken or does it contemplate taking to prevent the collapse of major banks that may not be able to absorb their energy loan losses.

Do you contemplate, for example, the necessity of multibillion dollar bailouts such as was necessitated in the case of Continental Illinois?

Mr. VOLCKER. At least a part of the premise of your question, Mr. Gonzalez, is that the countries won't be able to pay. Obviously all of these countries are "unable to pay" in the sense that they can't pay down the net of the loans outstanding over any short period of time.

The question is whether there can be a combination of internal measures and external financing that can enable those countries to continue to service their debts in a context of growth in their domestic economies over a period of time.

There is no question that job becomes tougher for some of those countries, and acutely tougher. But I don't think it is impossible. In some sense, as the challenge becomes greater, the urgency of taking constructive action becomes greater, and I think the potential of constructive action remains high in those countries.

But I will accept the premise that the total situation internally as well as externally creates some uncertainties and some strains. Are they manageable? I think, if the external strain is manageable as I suggested, the internal can be manageable, too.

We are in a better position for dealing with this than if oil prices had gone down to whatever level they're at now, say, 4 or 5 years ago, that is, from very suddenly from the higher levels that have been attained. To put it another way, we've already washed out some of those bad credits over the past 4 or 5 years and, having done that, I think that the remaining credits basically, on the average are stronger than what existed 4 or 5 years ago. They are going to be weakened, many of them, by this development, but I do think the situation can be managed with effort.

Mr. GONZALEZ. But, Mr. Chairman, how far are you willing to go and how many more Continental Illinois do you expect and how far are you willing to go to preserve the U.S. banking institution?

Mr. VOLCKER. I am not expecting any more Continental Illinois.

Mr. GONZALEZ. But, suppose you do get them?

Mr. VOLCKER. Well then, we will have to deal with them.

Mr. GONZALEZ. How far are you willing to go? You told me once before that if necessary you would use all of the U.S. powers that be to save those banks.

Mr. VOLCKER. I don't have all of the U.S. powers to be at my command.

Mr. GONZALEZ. All the resources available.

Mr. VOLCKER. But we certainly conceive of our responsibilities to use the resources that we have at our command to deal with banking difficulties and crises of the kind that you're contemplating—and that I'm not.

Mr. GONZALEZ. Well, I thank you. I have one more question, Mr. Chairman. I will submit it in writing because my time is up.

The CHAIRMAN. Thank you, Mr. Gonzalez.

Mr. Chairman, I'm constrained to very briefly mention that in answer to the question about the tax on imported oil, the people in the Northeast, nobody had too much chagrin for them and they conserved but paid through the nose. God almighty, I hope that now we are not going to punish them by saying: Well, we are going to make you; we are going to teach you how to continue to conserve by increasing that price with a tax. They have earned relief.

Mr. VOLCKER. I could have also added all the inherent difficulties that arise in that kind of an external protective arrangement, what you do to the exporters who rely upon energy and would have it at a higher price relative to their competitors abroad, how you might get into allocation problems, and all the rest.

The CHAIRMAN. If that gets to be a hot issue, we will have to really ask you to come up and tell us some more about these problems, and I am sure we will benefit from your knowledge.

Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

Chairman Volcker, you have alluded to a couple of questions that I have, but I would like you to be a little bit more precise, if you would please.

What is your assessment as to the state of the economy now? Is it lagging as some economists say? What do you see for the remainder of the year?

Mr. VOLCKER. The assessment is reflected in my statement where the most recent news, including news as recent as this morning that shows another increase in new housing starts, has generally been on the side of a more rapid rate of expansion than we had last year.

Members of the committee collectively are projecting more rapid growth in 1986 than in 1985, in a 3- to 3½-percent area generally and some ranging up to 4 percent or even more.

That is a stronger picture than we had last year. But I would put a couple of more footnotes on that. As I mentioned in my statement, demand was expanding quite rapidly last year, if I remember the figure correctly, it was something in the area of 4 percent and maybe even higher.

A lot of that demand was spilling out abroad. People were consuming and businesses were spending and the Government was spending, but a lot of the demand was satisfied by imports in increasing proportion.

We don't expect that to continue at the same rate anyway in 1986. Part of the faster GNP growth is a reflection of an absence of such rapid deterioration in the trade balance. In fact, I would hope that the trade balance would at least level off this year. I think that it is probably too early to expect any really significant improvement in the trade balance, except that it flows directly from the cheaper price of oil. Obviously our imports will go down because of the cheaper oil price.

But the volume of and prices of non-oil imports and increase in exports are going to take some time to materialize, in my opinion.

Mr. **Wylie**. OK. Taking that assessment into account and given the passage of Gramm-Rudman-Hollings and your statement on page 12, you say there is no escape from the need for a substantial element of judgment in the conduct of Federal Reserve policies. Is there going to be a change in the conduct of monetary policy given the schedule decline in Federal spending? How is that likely to influence or affect your job?

And may I say that there seems to be from reports some difference of opinion as to how that might impact on your job given the administration's view that efforts will need to be made to tailor monetary policy to fit the Gramm-Rudman-Hollings scheduled reductions in spending.

Mr. **Volcker**. I don't think there is much doubt, whatever the specific disagreements are within the proportions of that kind of effort, it makes our job easier. It relieves one large demand on our very limited demonstrated capacity to save, offers the prospect that interest rates will be lower than they otherwise would be, and will contribute to better balance internationally. All those things are positive and make our job easier.

At the same time, it is one of a number of factors working on the economy. The big new one that Mr. Gonzalez mentioned and emphasized, of course, was the oil situation. If those lower prices are sustained that releases a good deal of purchasing power to the American economy. The timing isn't quite the same, but more or less it is working in the opposite direction of the decline in purchasing power that some people see stemming from the budgetary efforts. The timing of that, presumably, is rather late in the year and in 1987.

So it is one of a number of factors that one has to watch. But, as a first approximation that budgetary restraint will bring its own reward in terms of lower interest rates, which in turn help stimulate other areas of the economy and offset any effects the budget restraint may have in removing purchasing power from the economy.

Mr. **Wylie**. Thank you, Mr. Chairman. I've been informed my time is expired.

The **Chairman**. Mr. Hubbard.

Mr. **Hubbard**. Thank you, Mr. Chairman.

We appreciate your visiting with us again, Chairman Volcker, and appearing before our Banking Committee to express your views and try to answer our questions.

Indeed, in many parts of the country you are a very popular man. You were called by Newsweek this week the second most powerful man in America and featured on the front cover in a story very complimentary of your efforts.

Having lived through the inflationary period of the late 1970's, we are well aware of your efforts to combat inflation since that time. Indeed, because of your guidance since 1979 as chairman of the Federal Reserve Board, America continues its economic growth.

However, in beating down inflation through our monetary policy, many economists suggest that a direct result has been a complete disruption in the value of farmland.

You are familiar with my district, a 24 county district in Kentucky, consisting of mostly farmers. In meeting with some farmers in Russellville, KY, just last month, they blamed their plummeting farmland values and their problems relating to farming on the Federal Reserve Board, fairly or unfairly.

On December 20 last year, our Subcommittee on General Oversight and Investigations, which I'm privileged to chair, conducted a hearing in my hometown of Mayfield, KY, on farm credit problems. We heard testimony from nearly 40 witnesses, including farmers, commercial bankers, representatives of the Farm Credit System and Government officials.

One of the problems most commonly cited by our witnesses was the need to stabilize farmland values. Daily farmland values continue to plummet causing increasing problems for farmers in terms of their debt to asset ratios which are so important to their borrowing abilities.

The problem for the farmers in my area indeed is very real. In fact, farmland is worth about half of what it was just 3 or 4 years ago.

I read today that the Farm Credit System, the Nation's largest farm lender, has announced a net loss of $2.69 billion for 1985, by far the largest in its 70 year history. Some predict 1986 losses could exceed $3.5 billion.

We are all aware of the recently passed financial assistance legislation for the System, but the problems facing farmers are only getting worse. Just recently our Secretary of Agriculture resigned, thinking that maybe someone else could follow him and do better for the farmers.

In your prepared statement today you briefly mention—and only briefly—the problems of agricultural lending. But if you would, in your opinion, what can be done in terms of Federal Reserve action to help the many negative effects that farmers continue to experience?

Mr. **Volcker**. Let me say, first of all, that those conditions that you described in your district are, unfortunately, typical of many of the agricultural areas in the country. There is no question that they are under very severe strain and pressure. There is no question that farmland prices have declined precipitously and to a considerable extent. That decline in farmland prices is a factor undercutting their credit raising ability and in some cases the value of the credits already on the books of the banking system or the Farm Credit Administration. As you mentioned, it is a serious and widespread problem.

Before touching specifically on what we can do about it in terms of our powers, I just would not want to let the opportunity go without saying I think the source of those difficulties, in a fundamental sense, arose in the inflationary period of the 1970's when you had conditions that were apparently conducive to a very rapid runup in land prices—a very speculative development that increased production. In a disinflationary environment many, many farmers are feeling a very difficult backlash from a situation that was not of their making but, nonetheless, was of the making of an inflationary situation.

I say that because I don't think we can find an answer to those problems that is reasonable and lasting in a context of reinflating. That's not the answer and that's not what we can do for them, in my opinion.

I do think the legislation passed by the Congress with respect to the Farm Credit Administration is very helpful in stabilizing the situation with regard to that institution.

Our specific powers to deal with this are rather limited. We have discussed with our examiners again and again the dangers of overreacting to this situation and the need to work with banks when the banks in turn are working with farmers and exercising forebearance where that is consistent with a workout situation; we do not want to create conditions in which land is further pressed on the market unnecessarily as a result of bad loans.

We have also, just this week, renewed a liberal seasonal lending program that we have for agricultural banks, so that if they face an increase in loan needs over this period of time they have simple and easy access to the discount window to meet those needs.

I do not argue that that is a terribly significant measure, because the basic problem out there is not liquidity, which we can deal with; it is creditworthiness, which is another matter, and is affected by our examination standards but is not affected by something like this seasonal lending program.

The **CHAIRMAN**. Ms. Oakar.

Ms. **OAKAR**. Thank you, Mr. Chairman.

Thank you, Chairman Volcker for being here today. You spoke, I think, in somewhat complimentary terms about Gramm-Rudman in your statement and I want to ask you a question about that.

Some economists project that the automatic cuts relative to Gramm-Rudman could hinder economic growth and certain economists indicate that a faster way and more responsible way to offset the deficit would be by raising a certain amount of revenues.

Do you agree that raising revenues might be a more expeditious way that would not harm economic growth, or do you still think Gramm-Rudman is the way to go?

Mr. **VOLCKER**. Let me make a distinction: I don't see that raising revenues is a better way to go about it than reducing expenditures, assuming that you find it politically practical to reduce the expenditures.

I don't think, as a first order approximation, it makes much difference in terms of the immediate impact on the economy whether you do it by raising taxes or reducing expenditures. I think there are longer-term reasons to say that it's better to reduce expenditures.

Let me say, as far as Gramm-Rudman is concerned, I certainly think the spirit of that is correct. You asked me whether it's a good way to go about it, that is, to be faced with a sequester order in September or October and have to suddenly reduce expenditures across the board, with some large exceptions, kind of willy-nilly. I don't think that's a good way to do budgeting and it can produce a certain amount of chaos and, obviously, inefficiency in itself.

I would hope that the approach will be not to rely upon that kind of across the board, forced savings, but to take a more discriminating approach in your budgetary deliberations over the next few months.

Ms. **Oakar**. Thank you. Let me ask you again about this. Your last statement relates to the world economy and you talk about the fact that we are a necessary participant.

With respect to international loans, I know that Mr. Gonzalez and others are concerned about the drop in oil prices and the problems in the oil industry.

I was going to ask you in the area of Latin America, Mexico, and so on, who are so debt ridden, do you see the Fed again stepping in and recommending assistance in our lending to meet the Mexican demands. Also I wonder if you would comment on the situation in the Philippines where so many individuals are withdrawing their money. It puts more of a burden on our American banks who have lent over there.

How does that crisis in the Philippines and the apparent crisis in areas like Mexico and Latin America, affect American banks and what is the Fed prepared to recommend?

Mr. **Volcker**. I really can't comment specifically about the Philippines. I don't know enough about what is going on there and I haven't got anything to recommend except one general comment which would apply perhaps specifically to the Philippines now but applies to other countries as well.

If a country is conducting policies that don't command the confidence of its own citizens and can't keep its own money in the country, that country is very difficult to help. One of the criteria for external help, I think, has to be, basically, policies that command the support and financial support of the country's own citizens.

When you look to Latin America or Mexico or elsewhere, I do think this is a situation in which—assuming that those countries take the strong measures that seem to be necessary in their own interest—we certainly should be in the posture of continuing to provide what complementary external support we can.

The Government itself hasn't provided much. Most of that has come from private creditors, but I think they have a stake, too, in maintaining the consistency of the effort and in maintaining the value of their own loans in those countries, by working with those countries to meet these new and intensified needs. But that rests upon the countries themselves, as always.

Ms. **Oakar**. Just one quick last point. Can consumers expect to see home loan mortgages continue to be reduced? Should people go out and buy a house now or should they wait another month? [Laughter.]

Mr. **Volcker**. I religiously avoid that kind of personal financial advice. The rates have been coming down.

Ms. **Oakar**. You have a lot to do with it.

The **Chairman**. Mrs. Roukema.

Good try Mary Rose. [Laughter.]

Mrs. **Roukema**. Thank you, Mr. Chairman.

Chairman Volcker, I do appreciate you being here today and as usual your analysis is both brilliant and comprehensive and I take no exception to any of your report.

I have two questions, one of which you may or may not want to comment on at length. And, that is the question of the quality of the employment figures, if you will. You've spoken about the decline in unemployment and you've spoken about increased employment and decline or at least stagnant productivity.

Some of the statistics I have read are frankly confusing to me as to where the employment, the reemployment is occurring. We are told that 60 percent of those who lost their jobs have gained their jobs, but more than half of that 60 percent have come in at lower levels.

Is there any comment that you would like to make about the direction of quality of employment?

Mr. **Volcker**. The first comment I would make is that if you're a bit confused about the relationship between the employment figures and some other indicators of economic activity, so am I.

Mrs. **Roukema**. Then I am in good company.

Mr. **Volcker**. They seem somewhat inconsistent. We have much stronger employment figures as reported than appear to be reasonable if the other figures are correct. My general impression is that the employment figures, particularly the so-called payroll employment figures, are among the most reliable of our statistics, which leads you to believe that maybe some of the questions would arise with some of the other statistics that don't look quite consistent and give this very low productivity number.

Having said that, I think if one looks at the most recent employment figures, they may have been affected by seasonal adjustment problems as they often can be at this time of year when you get big seasonal changes in employment, by weather factors in January and so forth. Even making about as much allowance as you can for those factors the puzzle remains. My impression is that it does not lie primarily in the employment statistics, but rather in the lack of consistency between those statistics and some others.

Mrs. **Roukema**. The analysis, you mean?

Mr. **Volcker**. Yes. The implied productivity is very low. Is it really that low? I find it a little difficult to believe, but that is a big question.

Mrs. **Roukema**. Well, if you would, any further comment you would have on that, particularly in the quality of those reemployment figures and the kinds of jobs that are being created, I would appreciate it if you would submit it in writing.

Mr. **Volcker**. I would be glad to give you some——

Mrs. ROUKEMA. The other question that I have, and I tend to agree with you that——

Mr. VOLCKER. I might say that a large number of the jobs are of course being created in the service area and in retail trade and so forth. One of the mysteries is why is employment in retail trade going up faster than sales. But, that's——

Mrs. ROUKEMA. I appreciate your comment. We would appreciate any further comments in writing, you have.

[Chairman Volcker subsequently furnished the following information in response to a request from Congresswoman Roukema:]

The data most often used to analyze industry employment patterns are collected by the Bureau of Labor Statistics (BLS) from a survey of nonfarm establishments. The accuracy and interpretation of the data are, of course, subject to a number of difficulties including adjustment for normal seasonal variation, the failures and formations of businesses, and possible response errors often associated with surveys of this type. Nevertheless, over longer periods of time, these data have been consistent with trends reported in other measures of economic performance.

Table 1 contains information on employment trends in some selected industries based on the BLS establishment survey. Although employment growth was broadly based in the 1960s, the data indicate that the growth of factory jobs slowed sharply in the 1970s. The falloff in manufacturing payrolls was exacerbated during the 1979-1982 period when manufacturing employment growth dropped nearly 5 percent per year. Since that time, about one-half of the manufacturing jobs lost during the 1979-1982 period have been recovered. In contrast to the experience in manufacturing, employment in trade and services continued to climb at a brisk pace during the 1970s, and even rose somewhat during the 1979-1982 period. In the current expansion, the trade and service industries have continued to account for most of the newly created jobs, with particularly strong gains evident at eating and drinking places, and business and personal service establishments.

Some further insight into the reemployment opportunities of workers who lost their jobs is available from a special survey of displaced workers compiled by the BLS. According to this survey, which studied workers whose jobs were abolished or plants shut down between January 1979 and 1984, about 60 percent of the workers who had been at their jobs at least three years before they were displaced were reemployed when surveyed in January 1984. As shown in Table 2, the industry distribution of workers displaced closely resembles the distribution of employment for reemployed workers in January 1984. Although reemployment patterns do show some shift out of manufacturing into services, it appears that many displaced workers either found new jobs in the manufacturing sector or were recalled to their old jobs. It is worth noting, however, that displaced manufacturing workers were more likely to be unemployed in January 1984 than were workers displaced from service-sector jobs.

Overall, the data suggest that the strong demand for service workers in recent years has been met primarily by new entrants to the labor force or less tenured unemployed persons rather than by experienced displaced manufacturing workers.

Although many of these more experienced production workers have returned to work as well, they generally were able to find reemployment within the manufacturing sector.

Table 1

EMPLOYMENT TRENDS IN SELECTED INDUSTRIES
(Based on nonagricultural establishment data)

	Share of total employment (1985-Q4) (percent)	- - - Average Annual Percent Change[1] - - -			
		1959 to 1969	1969 to 1979	1979 to 1982	1982 to 1985
Total nonfarm	100.0	2.9	2.5	-.7	3.7
Private	83.3	2.6	2.4	-.7	4.1
Manufacturing	19.6	1.9	.4	-4.7	2.3
Retail trade	17.9	3.1	3.2	.2	5.2
Eating and drinking places	5.8	4.5	6.2	2.0	6.0
Other	12.0	2.7	2.2	-.6	3.8
Finance, insurance, and real estate	6.1	3.3	3.5	2.0	4.1
Services	22.6	4.7	4.4	3.2	5.3
Personal services	1.1	1.3	-.3	1.0	7.1[3]
Business services	4.6	8.3	6.3	2.9	11.3
Computers and data processing[2]	.6	n.a.	14.5	9.2	15.1[3]
Health services	6.4	7.0	5.7	5.0	2.3

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1. Percent changes from fourth quarter to fourth quarter.
2. Data available starting 1972.
3. Average annual percent change from 1982-Q3 to 1985-Q3.
n.a.--Not available.

Table 2

Displaced Workers by Industry[1]

	Industry of Lost Job		Industry of New Job[2]	
	Thousands	Percent	Thousands	Percent
Total Private	4700	100.0	2810	100.0
Construction	401	8.5	253	9.0
Manufacturing	2483	52.8	1418	50.5
Durables	1675	35.6	954	34.0
Nondurables	808	17.2	464	16.5
Transportation and public utilities	336	7.1	191	6.8
Trade	732	15.6	399	14.2
Finance and Services	599	12.7	378	13.5

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1. Taken from a survey sponsored by the Employment and Training Administration and conducted as a supplement to the January 1984 Current Population Survey. Displaced workers were defined as persons who (1) lost a job between January 1979 and January 1984, (2) had worked at least three years in that job, and (3) lost it because of the closing down or moving of a plant or company, slack work, or the abolishment of a position or shift.
2. Includes only persons with jobs in January 1984. Another 1.9 million displaced workers either were unemployed or out of the labor force in that month.

Mrs. **Roukema**. I would like to point out with respect to the monetary growth and the judgment factor, as you have so clearly indicated is your standard, how do you respond to remarks or statements attributed to administration sources that suggest that your approach would be destabilizing? I think the quote is "The administration strongly recommends that deceleration of monetary growth be achieved gradually and predictably in order to avoid the restrictions of real economic activity that is associated with abrupt declines in money growth." Is that statement inconsistent with Fed policy at this point?

Mr. **Volcker**. It's not inconsistent in most general terms, but I think we have had a recurrent difference in perspective with some people in the administration who have put very heavy emphasis on the steadiness of money supply figures and particularly M1—maybe not from month to month but from quarter to quarter and certainly from year to year.

I think, from where we sit, 1985 was a clear illustration. M1 went up rapidly. Was that appropriate or not? For the reasons that I explained in my statement, our judgment was, all things considered, some bulge in M1 was the least of evils, if I could put it that way. It worries us a bit, because it was high and I would like to see it come lower, and our targets project it coming lower. So there is no disagreement in that sense.

Sometimes we have been willing to allow shorter term fluctuations in the light of all the circumstances and some others have said that's a mistake and we ought to keep on the straight and narrow and, to overstate it a bit, put things on auto pilot and keep the money supply, particularly M1, rising at a steady rate of speed. That is a difference of opinion.

Mrs. **Roukema**. Thank you, Mr. Chairman.

The **Chairman**. Mr. Barnard.

Mr. **Barnard**. Thank you, Mr. Chairman.

Mr. Chairman, the DIDC and all that it entails expires at the end of March. As we deregulated interest rates and allowed more and more transaction accounts with interest, I believe the Fed had some difficulty with the various statistical measure of money and some with velocity. Do you expect any more of this when DIDC expires?

Mr. **Volcker**. We have still got a lot from the earlier actions. We don't expect these rather limited changes implied by the expiration of the DIDC to have a very pronounced affect, simply because there's been so much deregulation already.

Minimum requirements will be eliminated, but many banks have probably maintained some minimum requirement anyway and it is a relatively small amount. It eliminates the rate ceiling on NOW accounts, but we already have super-NOW's and other substitutes that are freely available. In contrast to what has happened and which continues to affect the figures, we don't think the new moves will be terribly significant.

Mr. **Barnard**. You think most banks have adjusted to it all?

Mr. **Volcker**. Yes.

Mr. **Barnard**. Mr. Chairman, you indicated in your statement some aberrations in the quarter of last year in velocity, and you note them in your testimony and in the policy report itself.

Can you give us briefly, why did we have this aberration do you think in velocity in the last half of 1985?

Mr. **Volcker**. I wouldn't just state it for the last half of 1985. I think this has been developing for some time and it is most pronounced in the second half.

I think the biggest single reason—and it's related to the deregulatory trend that you mentioned, the payment of interest on transactions accounts and the availability of savings accounts that have transactions features—is the decline in interest rates that began rather sharply late in 1984 and continued more or less through last year; this made it cheaper, in effect, to hold cash in a form that is recorded in M1.

You earned interest on that, other interest rates went down and you didn't loose so much by holding your money in the form of a NOW account.

Mr. **Barnard**. So the money didn't turn over as fast, in other words?

Mr. **Volcker**. The money doesn't turn over so fast. To put it into jargon, it is the biggest savings component and the general reduction in market interest rates made it more attractive, at the margin, to hold money.

Now, there are other things going on that probably contributed to more cautious cash management besides the decline in interest rates. People are willing to hold more demand deposits which have no interest rates at least on the face of it. There may be more caution as a result of the E.F. Hutton incident, or otherwise, in managing cash balances. People just want to hold a little more margin of cash in the bank in managing their affairs day by day.

We could not have been successful in taking account of all these things and fully satisfying ourselves that we have the precise answer. I can't produce an equation for you that takes all these into account and produces the precise velocity decline that appeared last year. We can go some distance in that direction, but we can't fully explain it with precision. But these are the kinds of factors that enter in.

Mr. **Barnard**. Mr. Chairman, just as we get to feeling comfortable with some understanding of what M1 is and M2, and M3, you now come up with MQ, and this is in appendix B of the policy report. What in the world do you mean by MQ?

Mr. **Volcker**. I would recommend that you take that appendix to the policy report and send it to your professors in Georgia and elsewhere for their analysis because that is what we are really looking for.

It is a complicated weighting system for M1 that tries to take account of the different moneyness of different elements in M1. We've got this mixture of savings components, transactions components; and different types of money are used with different intensity. and in concept this is a nice idea, to try to measure how much or what weight different parts of the money supply should really carry in something called money and used for transactions purposes.

Mr. **Barnard**. So, this means money quotient?

Mr. **Volcker**. It means, money; I don't know, what does "Q" mean? [Laughter.]

Mr. BARNARD. I didn't mean to stump you, Mr. Chairman.

Mr. VOLCKER. I don't think it means money question. [Laughter.]

Mr. BARNARD. Money quotient is what I said.

Mr. VOLCKER. It may be money quotient or quantity. I don't know. [Laughter.]

Mr. BARNARD. Well, I am glad that you are as confused as I am. [Laughter.]

Mr. VOLCKER. I know what it is, but I am not aware of the title, of just why we picked "Q".

Mr. BARNARD. My time has expired, unfortunately.

Mr. VOLCKER. One of my staff informed me on that.

The CHAIRMAN. It must be some Latin——

Mr. VOLCKER. I was right. Money quantity. [Laughter.]

The CHAIRMAN. I thought perhaps it was some Latin word that one of your monks down there came up with. [Laughter.]

Mr. VOLCKER. It is a complicated concept, but it is an attempt, which needs a lot more work, to try to adjust for the different quality—and it could be money quality almost—the different quality in terms of money as a component of the money supply.

Mr. BARNARD. I didn't mean this to be a jeopardy game, Mr. Chairman.

The CHAIRMAN. Well, I will tell you, next comes Chuck Schumer. So you gave him an introduction.

Mr. VOLCKER. We would like that to be out in the academic community so that they can look at it a little bit.

The CHAIRMAN. Mr. Schumer.

Mr. SCHUMER. Thank you, Mr. Chairman.

Mr. Chairman, I am glad you came up with what the "Q" meant because for a minute I thought you were talking about money quintillion, and there would be real problems in our money supply system if that were the case.

Let me first, Mr. Chairman, say that you have been called the second most powerful man in America. I, however, think you are the first most successful man in America. The whole prosperity that we have had, which our President takes credit for, really belongs to you.

The credit belongs to you because you had the courage and the guts to wring inflation out of this economy which maybe the political system could not have done. Now people are beginning to be able to feel that they live in an inflation-free environment—and they can look toward the future and invest.

When I hear the administration people come up before this House day in and day out and take credit for this prosperity without mentioning your name, I think they are not being fair.

Let me ask you a couple of questions—first, on the budget and Gramm-Rudman.

Yesterday Director Miller told us on the Budget Committee that the President's 1987 budget assumes the Fed would slow down money supply from its present, in his words, inordinate growth rate. Do you agree with this description of Federal Reserve Policy and has the Fed agreed to tighten up on the money supply as Miller has suggested? Or are the President's budget's assumptions on the money supply not correct?

Mr. **Volcker**. As our new target ranges suggest, we are certainly looking for slower growth in M1 this year than last year. Whether it was inordinate or not last year, I would certainly agree—unless something really strange is going—on, that a continued growth at that rate of speed would be inordinate. I do not believe it was in all the circumstances of 1985, but I wouldn't like to see it continue.

Mr. **Schumer**. Thank you.

The next question, Mr. Chairman, is on Gramm-Rudman. Now that a court of appeals' decision has said a key portion of Gramm-Rudman is unconstitutional, there is less certainty that the drastic nature of the cuts in Gramm-Rudman will actually come about. But given the fact that you have to make monetary policy ahead of when we have to make budget policy because of the monetary policy lag, you have to guess how much Gramm-Rudman fiscal restraint is actually going to occur.

Which do you believe is worse for the Federal Reserve to err on the side of monetary restraint or to accommodate an increase the money supply hoping that Gramm-Rudman will fully go into effect? If you had to choose which way to lean, which would you?

Mr. **Volcker**. I think that is going to depend upon other factors as well as Gramm-Rudman. We have to make some judgment about that, and we assume that the budget will be coming down. But that is not a terribly pressing decision given that it doesn't take effect in a big way.

I am not talking about what was already done, this $11.7 billion, but I am looking toward the bigger cuts that are still sometime off. We have got many other cross-currents in the economy right now, including the dollar, which is a potentially inflationary force in the economy and that we have to take into account in the here and now.

Mr. **Schumer**. I get the feeling from your testimony, although you did not say so, that in many ways you feel the dollar has fallen enough.

Would you agree with that or would you hope it falls some more?

Mr. **Volcker**. I haven't got any hopes in that respect. I think it has fallen enough in the sense that it has fallen quite a lot and I don't know where the dollar is going to be over a period of time. But I certainly don't think it is anything we are interested in forcing, quite the contrary.

Mr. **Schumer**. What would be your reaction if the Japanese wanted to try to bolster the dollar a little bit? There was some talk about that last week.

Mr. **Volcker**. I think there is perhaps a strong implication in my statement that in some countries abroad that have relatively sluggish growth—and I certainly put Japan in that category—that one of the most helpful things they could do is to do what is necessary to get their growth moving.

Mr. **Schumer**. But they are already talking about bolstering the dollar. So do you think there is any real chance that Japan will do that?

Mr. **Volcker**. They reduced the discount rate recently, and I think that was a helpful move in the right direction. That is a big economy, and it is being subject to a restraining influence from the appreciation of the yen.

I think the question, and this is under discussion in Japan, is whether they have done enough to expand or restore the forward thrust to their economy. It has been a miracle in the past, but it is not any miracle right now. Their growth is rather slow and it has been heavily dependent upon external factors.

Mr. SCHUMER. Can we do anything other than exhort the Japanese and the Western European countries to increase the growth in their economies?

Mr. VOLCKER. No, except I think the appreciation of the yen itself creates some incentives in that direction. I hope so.

Mr. SCHUMER. Mr. Chairman, my time has expired.

The CHAIRMAN. Mr. Leach.

Mr. LEACH. Mr. Chairman, I would like to move a little bit away from the abstractness of MQ and talk to some of the concerns of Mr. Hubbard about the agricultural economy.

I think the Fed understands the problem extremely well in numerical terms. I would just like to stress that the problem is getting worse. The human toll is rising in the Farm Belt and the potential of violence is not out of the question. This is becoming the real concern of many agricultural bankers.

The question arises as to what we do with regard to the agricultural banks themselves. There are four or five broad areas of potential options. One is to let the agricultural banks go under and maybe precipitate that occurring.

The second is to come up with some sort of net worth or loss deferral program.

Third, the FDIC or the Government can help capitalize the rural banks and perhaps take stock in exchange,

Or, fourth, we can come up with some sort of interest rate buydown or warehousing approach for agricultural banks.

It is my understanding that States exercise greater regulatory supervision than does the Fed in regard to problem banks. But the FDIC has certain responsibilities in this area as well.

My query is, do you have a contingency plan to deal with rural banks beyond what you have already announced, or do you have any advice to Congress in this regard?

Mr. VOLCKER. We don't have any contingency plan or a black book that we are going to pull out at some point. I don't think that is the nature of the problem. But you have raised some questions that we have been considering and that are very relevant as far as the existence of those banks is concerned.

As you know, many of those agricultural States have very tight limits on branching which clearly make it more difficult, in circumstances where an existing bank is in trouble or fails, to maintain banking services in that community to the detriment of the community.

Those small banks are also not eligible for purchase under the Garn-St Germain provisions where an out of State bank can come in and pick up a failing bank.

I think those are two areas, structurally, that rather urgently need some attention so that some of these failing bank situations can be dealt with more expeditiously and more effectively in a way that preserves banking services in those communities and minimizes the destruction involved, so that I would have very strong recommendations on that.

On the question of net worth certificates or delaying write-downs of loans, we naturally have a certain reluctance to change straightforward accounting standards.

I think a more effective approach for a bank that can make it—and we would do this anyway—is to recognize in our application of supervisory or regulatory policies that some of those banks may have to deplete their capital for a while. That is what the capital is there for.

We are fortunate that a very large proportion of agricultural banks entered into this situation both with high capital and good profits. By and large those profits are under strain now and the capital is being affected.

But there is a cushion there which should be used and should be used before we have to turn to what might be thought of more in the area of gimmicks. But we have looked at that and we will be responding to some other congressional requests more precisely on that point.

Whether there are possibilities or opportunities for the FDIC in selected instances to supplement capital is a question that is more appropriate for them.

The Federal Government has had an interest rate buy-down program, as you know; my understanding is that has not been used at all heavily. It has been used practically not at all because of resistance by the banks at least, and maybe the borrowers as well as the lenders.

Now whether that should be made more effective is something that will be looked at. It looked to me like a reasonable program when it was enacted a year or so ago, but it wasn't used.

Mr. LEACH. Good. Well my time has expired. Thank you, sir.

The CHAIRMAN. Mr. Torres.

Mr. TORRES. Thank you, Mr. Chairman.

Chairman Volcker, you stated in your remarks, to be specific on page 32, that distorting the effects of extreme exchange rate volatility makes that effort really almost an aspect of our re-examining the international system worthwhile. Are you in effect suggesting that after 40 years we might revisit Bretton Woods?

Mr. VOLCKER. No, I am not going that far and being that precise. All I am suggesting is that we have had enough volatility it seems to me over the last 15 years that it is worth raising the question as to whether some different arrangements might be made here looking toward more stability than what we have had in that period of time.

I am not suggesting that we go back to the Bretton Woods system as originally conceived. That certainly would have to be changed some. This gets into a lot of complicated areas and it goes through a whole spectrum from relative floating to relative fixity and there are a lot of way stations in between.

Mr. TORRES. Didn't Treasury Baker's meeting last year in New York with the G-5 group indicate that we need a better coordinated system to deal with the Western nations, the industrialized nations on exchange rates?

Mr. VOLCKER. I think that meeting explicitly said that in that particular setting and given the particular set of facts surrounding the situation at that time a certain coordination was useful and desirable. That coordination was expressed of course most directly, but perhaps at least fundamentally in an intervention in the exchange market. But there was also a good deal of discussion of underlying policies, including the importance of the United States in dealing with its budgetary deficit and the importance of other countries taking complementary action.

In that particular circumstance there was certainly discussion of the need for complementary and coordinated action.

I think the question raised by international monetary reform discussions is whether institutionalize to a greater degree mechanisms for achieving that coordination. The G-5 meeting didn't institutionalize anything in and of itself.

Mr. TORRES. But you wouldn't go as extreme as I indicated to a Bretton Woods type of meeting?

Mr. VOLCKER. All I am suggesting is that some exploration of the problem in a positive framework is desirable. I am not implying any particular mechanism, such as the pre-1971 Bretton Woods mechanism. That is one of a variety of ways you can run it.

Mr. TORRES. Thank you, sir.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. Chairman, as always, your testimony is comprehensive, and this time perhaps more than others something soothing, somewhat. But let me——

Mr. VOLCKER. I don't really mean it to be entirely soothing. I don't want to disappoint you.

Mr. LEVIN. No, you didn't disappoint me. [Laughter.]

Indeed, I would like to try to apply it to some of the hard decisions we have to make because I think it is somewhat soothing in the sense that it is abstracted a bit from our day-to-day life here. And I would like to see if you might be willing to take some of your testimony and some of your premises and apply them to the issues that we face in the next months.

The first is on the deficit, on page 6, and then I want to ask you briefly about tax reform and if possible about the trade imbalance.

On the deficit you on page 6 talk about that you know the effort will continue to require the hardest kind of choices.

Mr. Gonzalez asked you about one aspect of that. Would you be willing to try to take it from the somewhat abstract and comment on the choices we have to make and any advice you would like to give us or any comments? I know you don't like to give us advice, but any comments?

Mr. VOLCKER. I don't like to give you too many comments about where to go on the budget.

Mr. LEVIN. I know, and I was afraid you would say that.

Mr. VOLCKER. Not because it is not terribly important, but obviously because it involves intensely political decisions in the broadest as well as the narrowest sense of the word that are not my bag.

Mr. LEVIN. No; it is not your bag, but when it is this removed from the decisions we have to make I think its value becomes more limited. You don't want to comment at all on the issues of the balance between cuts and expenditures and revenue needs? Maybe you could use the handle that one might have more impact than the other on monetary decisions. I don't know in what way, but you must have some thought about the dilemma that we face here in the Capitol and that the Nation faces about how we get out of the ditch we are in?

Mr. VOLCKER. My thoughts on that dilemma is that indeed you must move toward bringing the deficit down as soon as possible at a reasonable rate of speed and that that is important to monetary policy and it is important to interest rates.

Just how you do that and certainly what type of expenditures you cut I may have some opinions about as a citizen, but I don't have many opinions about it as Chairman of the Federal Reserve Board.

And, indeed, from the standpoint of the performance of the economy, as I said earlier, I think the more you do on the expenditure side the better, and if you can do it all on the expenditure side—fine, from the standpoint of the performance of the economy.

But if you reach the judgment that you can't do it on the expenditure side, I personally have never ruled out the idea of doing it on the revenue side given the importance of getting the deficit down.

Mr. LEVIN. Any further comments if the Congress had to move on the revenue side as to which might be the more prudent course? You commented on the oil import rate.

Mr. VOLCKER. I give you a very abstract answer and try to make it a little less abstract. You try to do it in a way that affects incentives and savings and so forth as little as possible, which I think drives you more toward the kind of taxes that affect consumption. In the present situation, let's say, with the oil price falling, maybe there is an opportunity, if you had to raise revenues, to raise them in that area. It doesn't have to be by an oil import fee. There are more direct taxes that could be done in the energy area.

Mr. LEVIN. My time has expired. Maybe somebody else will pick up this question, or I will ask you in some other forum regarding tax reform and also the trade deficit, because in the latter I think we have some difficult decisions to make, including about unfair trade practices and your testimony is one or two steps away from those very concrete decisions that have to be made here.

Mr. VOLCKER. If the chairman would permit me, I would like to volunteer an answer to the general question that you started out with and be more specific in terms of your legislative responsibilities and as a member of the Banking Committee. Let me just give you a list of priorities here.

Close the nonbank bank loophole.

Close the nonthrift loophole.

Modify the Garn-St Germain emergency acquisition procedures as we discussed with Mr. Leach a moment ago.

Limit nonbanking activities of State banks when necessary for safety and soundness reasons.

Streamline the Bank Holding Company Act procedures.

Consider reasonable powers for commercial banks.

Consider who should have access to the payments mechanism, and the interstate banking questions.

I may be coming to perhaps a lesser order of urgency. But those are matters which are on the docket of this committee and the Congress and some of them are I know before the Rules Committee. That is end of speech.

Mr. BARNARD. Mr. Chairman, would you yield for just——

Mr. LEVIN. I would love to. If the chairman would give me 10 seconds , it is yours.

The CHAIRMAN. The chairman would like to do that, but I have kept everybody to the time constraints and we have a lot of Members who want to ask questions. If any of the Members would like to stick around, we will have a second round.

Mr. PARRIS. Mr. Chairman, I congratulate the Board on the reduction in interest rates. I think that was a step in the right direction for the American economy.

I have just one very brief question. The prime rate is and has been for years the traditional and historic benchmark used by the financial community and the economy as a whole for consumer finance and margin accounts and inventory financing rates and whatever.

Mr. VOLCKER. But not for consumer finance, I don't think, Mr. Parris.

Mr. PARRIS. Well, to some extent. The cost of money is what I am trying to get at.

My question, Mr. Chairman, is very simple. Why is the prime rate maintained at such an artificially high level, and before you answer that, let me just make another observation or two.

Historically and traditionally there has been a margin between the inflation rate and the prime rate, as we all know, of substantially less than what exists today in the current margins.

Although, as you have pointed out, there is at the moment a balance in the capital markets and that sort of thing. in the internal capital markets, and most economists predict a low and level inflation rate over the foreseeable future.

If the cost of money is something around 7 percent or give or take a little, why is the prime rate still at 9½?

Mr. VOLCKER. Let me say, like a lot of things the prime rate is not what it used to be; it is a less significant rate than it was——

Mr. PARRIS. But it is not what we would like it to be.

Mr. VOLCKER. It is still an important rate, there is no doubt about it. And it has remained unchanged, I don't know for how many months, but quite a few. It may, on historic grounds, be somewhat higher in relationship to the banks' cost of funds than traditionally, but I don't think that has been dramatically so.

Banks are borrowing at something under 8 percent. The Treasury bill rates are around 7 percent, but the banks' borrowing costs are higher than that, so you have about 1½- or 1¾-percent difference, and that apparently, under the current situation, has not been enough to induce the banks to lower the prime rate.

Mr. PARRIS. Do you think the banking community is fattening its bottom line retained earnings to offset anticipated losses?

Mr. VOLCKER. I think the banks are cautious on that score, yes. I think there are competitive pressures that bear upon those rates, too, and the competitive environment is a given. I do think that banks are experiencing larger losses than typical and that they are concerned about their profit position and maintaining the profits that are necesary to absorb the losses.

Mr. **Parris**. Well many of them are in enjoying record profits, as I understand it.

My question, Mr. Chairman, would you venture——

Mr. **Volcker**. It is quite a mixed picture. Some of them are enjoying pretty good profits and others are not.

Mr. **Parris**. That is correct. Would you anticipate that that traditional spread will remain high for the foreseeable future? What is going to happen to the prime rate?

Mr. **Volcker**. I am not going to predict the prime rate. I think it will depend upon what happens to other short-term rates.

Mr. **Parris**. If you lower the discount rate, would it impact on the prime rate?

Mr. **Volcker**. If we lower the discount rate just as a matter of analysis, and other market rates went down, it would presumably impact upon the prime rate, yes.

Mr. **Parris**. And would it at the same time, if you reduced the discount rate by one-half or whatever, would it reduce the automobile financing charge, credit card interest rates, and things of that kind? Is there a direct relationship?

Mr. **Volcker**. That relationship is much more distant. As you know, automobile financing charges, because of competitive pressures among the automobile companies, have been extremely low in many recent periods. You can get automobile loans at a cheaper rate than the banks can borrow money in the money market or, at as cheap a rate, because they have used that as a competitive tool.

As you get into credit card rates and, to a lesser extent, personal loan rates, you have components of costs there, both losses just on an actuarial basis, and the costs of administering those loans that loom relatively heavy in the rate computations.

So the relationship between those rates and a limited change of money market rates is not very close.

Mr. **Parris**. Thank you, Mr. Chairman.

The **Chairman**. It would be a real shocker to see credit card rates come down, believe me. That is a winner for the banks. Mr. Carper.

Mr. **Carper**. Thank you, Mr. Chairman.

Chairman Volcker, welcome back to our committee and thank you for your testimony.

You went through a real quick shopping list there in about 10 seconds in response to I think—or maybe not in direct response to a question posed by Mr. Levin.

I just want to ask you to go more slowly through that shopping list. [Laughter.]

And I might ask you, if you will, to try to set some priorities. Before you do that, let me just preface your response by saying that I enjoy a certain sense of frustration in having served on this committee for 3 years and seeing so little of our effort actually being debated on the House floor. Part of that fault is our own and part of that quite frankly belongs to another committee.

Mr. **Volcker**. I understand that you have as much reason for frustration as myself in this area. I would try to put the priorities this way. I think you face a kind of basic structural question as to whether there is something special about the banking system that goes with the safety net and needs to be protected on the one hand by insurance, by discount window privileges and all the rest, and whether that is a franchise that should be to some degree protected from those who don't enjoy both the protections and the regulation and supervision that go along with it.

That gets reduced to this very technical question of nonbank banks. That is what is at issue here. What kind of banking system do we want?

Do we want a banking system in which banking services are being provided by commercial firms, investment houses or whatever, that are essentially unregulated. It's a perfectly legitimate business, but if they are doing a banking business, should they be regulated as a bank? That is a kind of core issue, because if you don't do something about it, events are going to take it right out of your hands as they are doing now on the basis of existing court decisions; you have to act on this as a matter of urgency.

Now right along with that, because there is so much overlap between the industries, goes the thrift question. If you are going to define a bank, you have to define a thrift and subject it to some of the same opportunities and limitations. Those two are Siamese twins and they are H.R. 20. That is the subject matter of H.R. 20.

Now once you have resolved that core, then a lot of other questions—and they are pressing—arise and, of course, as you know, there is the question of the value of getting a more comprehensive approach and the questions of what are legitimate powers for banks and thrifts and bank and thrift holding companies.

I think events of the past year have certainly shown the urgency—and the Federal Home Loan Bank Board has felt quite strongly about this—of limiting the kinds of activities authorized and permitted by States for institutions that are insured by the Federal government and are part of this core banking system.

I personally put that very high on the priority list in dealing with what seems to me so obvious and evident a problem, illustrated in the extreme by some events in the past year; that certainly has to be put very high on the priority list.

I would certainly like to see some additional powers that seem reasonable for bank holding companies. I wouldn't put a particular priority on any one of those, but some reasonable combination of them seem to be important.

The interstate banking question is important outside the area of failing institutions. One can argue in that case that things are changing so rapidly under the force of events and the force of State legislation that it doesn't have the same urgency as some of these other problems. They are all interconnected.

Many banks, I think wrongly, are very reluctant to do anything about nonbanks because they want to use them to go interstate. Now, as a matter of substance, I don't see anything the matter with that as part of public policy.

What I don't want to see is the nonbank bank loophole used by nonbanks to go into the banking business. So to deal with that issue it is also logical and reasonable to deal with the interstate issue, although, as I say, a lot of action is going forward on the

State level which ameliorates that issue, but it is not all that coherent; nonetheless it is moving.

There are other issues of deposit insurance reform that are very complicated. I don't myself put them right in the same degree of urgency. I think they are very important, but they are not right at the edge of the table, so to speak, as some of these other issues are partly, because they are so complicated and need to be thought about awhile.

Mr. CARPER. My time has expired. Thank you very much for that explanation.

Mr. VOLCKER. I appreciate the opportunity to go over this list.

Mr. CARPER. My pleasure.

The CHAIRMAN. Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman.

I want to salute you, Mr. Volcker, because I think that your conduct of monetary policy has been a victory of pragmatism over the intransigents of policies which have persisted in $200 billion deficits and a merchandise balance of trade deficit which is very high. I think this is obviously a watershed in terms of the Federal Reserve Board and the sort of paralysis that gripped it with regards to monetary aggregates and other things.

I don't care what you call it, just so long as we can do things to the discount window and deal with some of the real problems. I think without that we would have had a much tougher time both from an unemployment standpoint and from interest rates. I think it is the one area where we have seen some help for people in terms of home ownership and businesses and maybe even the farm economy would be far worse without that sort of pragmatism.

It perhaps isn't a crown that you want to wear, Mr. Volcker, but nevertheless I think that it is one that most of us are cognizant of.

That is my conclusion and these are my questions. [Laughter.]

On page 16 you talk about Federal regulation and State regulation being the problem in Ohio and in Maryland. Do you believe the Federal regulation is so superior, or do you think it is the quality of the insurance that exists there?

Mr. VOLCKER. I think we have got lots of problems in Federal regulation, and in that sense I don't want to be throwing any stones But I think that no one can go through the Washington Post in recent months and its revelations about those Maryland institutions and think that that is an ideal kind of situation.

Mr. VENTO. Well, I think we have got a few problems even if the Federal insurance isn't reported as vividly in the Washington Post. But I just want to point out that I think——

Mr. VOLCKER. We have got problems within the Federal system. No doubt about it.

Mr. VENTO. I think, Mr. Chairman, that our problems are as serious, if not worse, because they are multiplied many times. I think Ohio and Maryland had the difficulty of a limited State insurance and a quality of insurance that was far different and we do have problems.

Mr. Chairman, recently you have dealt with efforts in with junk bonds and you comment on nonbank banks. Both of these are important to deal with monetary policy and with of course especially with junk bonds with where credit goes.

Do you want to comment today about the nonbank bank role with monetary policy? That is important from the standpoint of conduct of monetary policy, is it not?

Mr. VOLCKER. I am thinking of the nonbank banks primarily in terms of the structure of the banking system and the safety and soundness of the banking system, but that of course bears upon monetary policy—not in an immediate sense, but it certainly bears upon the operations of monetary policy over a period of time.

We operate through a banking system, and if you drastically change the character of that banking system, it is going to have some implications for monetary policy, but my focus right now is on structural and safety and soundness questions.

Mr. VENTO. The junk bond issue in terms of where credit goes is important, Mr. Chairman.

Mr. VOLCKER. I commented in my statement about my continuing concern about the degree of leveraging in the economy. I don't think you can measure that with any precision by these aggregate statistics, but they are suggestive, and I certainly don't think that all low-rated bond financing is bad. That is the way many companies have to finance.

Mr. VENTO. Mr. Chairman, the velocity question has been much in discussion. CBS recently had a report which indicated the amount and the survey that was done in terms of the amount of money in circulation. The disparity was—in other words, the estimate was $172 billion and they found $18 or $20 billion in circulation in a survey.

Are you familiar with that study, the difference being $150 billion in terms of velocity? What does that mean in terms of the conduct of the monetary policy when relying on a figure that is apparently in error?

Mr. VOLCKER. Well the figure isn't in error. The figure for the amount of currency outstanding is not in error by any substantial amount.

Mr. VENTO. Well I think that the amount in circulation though——

Mr. VOLCKER. The amount in active circulation is very hard to identify, but I think the implications of that for monetary policy are very limited. That has been true I suspect for a long period of time, and the only thing that would have an implication for monetary policy is if you had a drastic shift in the short run between the amount of currency being actively used and the amount of under the mattress or abroad or wherever.

We go on the I hope not too comfortable assumption that those shifts are not drastic on a year-to-year basis. Now if they were drastic and it began affecting the money markets and the economy, we would have other evidence of that in abnormal relationships between the amount of currency in circulation, interest rates and other factors. So we wouldn't know it with precision, but we could adjust our policy to take account of it as that became apparent. I don't think that is a big problem in the conduct of monetary policy.

Mr. VENTO. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McKinney.

Mr. MCKINNEY. Mr. Chairman, it is a pleasure to see you again. I was delighted to hear from the supply siders in Newsweek that you are watching Reeses peanut butter cups, and I will put in a plea from my 5-year-old granddaughter that you watch Reeses pieces as well and leave it at that. [Laughter.]

There is one issue that I tend to be very partisan about and find myself agreeing with you and the courts on—junk bonds. I laughingly underlined the term at least seven times in a letter.

Living in the corporate capital of America I tend to find that the jump into junk bonds and the belief that all the parts are worth more than the whole is mind boggling. I am not saying that it isn't true in some cases, but I have a distinct feeling from your pronouncements that you are somewhat opposed to the financing of corporate takeovers with junk bonds, though I don't ever question or even correct your testimony.

I have become increasingly concerned because it is just one example of what is increasing under State legislation while we in the Federal Government insure them.

Mr. VOLCKER. We are not insuring these junk bonds, and let me——

Mr. MCKINNEY. Well we are insuring the banks though that buy them in California and Texas.

Mr. VOLCKER. Banks by and large can't buy low-rated bonds.

Mr. MCKINNEY. Excuse me, S&L's. I apologize.

Mr. VOLCKER. Some S&L's can. But let me make a distinction between two things. That ruling of ours and interpretation of ours which attracted so much attention was a limited ruling which arose from an application of the law on margin requirements which we administer. We were faced with the issue of whether certain arrangements that could be involved in corporate takeovers in fact involved the issuance of debt, whatever its rating. It wasn't a junk bond issue, but it was whether it involved borrowing money to purchase stock, which is what the margin requirement applies to.

We decided that in the limited set of circumstances described which are used in some big takeovers, yes, the margin requirement did apply on its face. That was the interpretation. It was a technical ruling that while the stock did not actually secure the loan on the face of the document, in practice it did, and that was the interpretation that was made.

Now a different issue, although these overlap, is the question of whether there is in some sense excessive leveraging of businesses. That is a much more difficult issue, and I think it deserves a lot of exploration. It is not under our jurisdiction exclusively or primarily, but it is an important subject which comes to mind because you can observe that a lot of it is going on.

We had $100 billion of equity retired in this country last year, and one wonders that, given the general feeling that we don't have enough equity, whether it is really all that great to be having $100 billion of it retired out of these operations.

Now it seems to me that the strongest single incentive toward this kind of behavior lies in the tax law. The fact that we have double taxation of dividends or the allowability of the interest deduction—or however you want to express it—means that there is an asymmetry in the tax treatment of raising capital through equity and raising it through debt, and it just looks a lot cheaper the way the tax laws are written to raise it through debt.

Plus there are a lot of explicit preferences in the tax bill now and the real estate area and elsewhere that because of the tax benefits that ensue give incentives toward very highly leveraged operations.

I think if you want to deal with this problem in any kind of a realistic and fundamental sense—and I think it is a problem—you have got to begin looking at the tax laws.

Mr. McKinney. You said it beautifully and thank you for getting it on the record.

Let me ask you one other question before my time expires.

The last time I played with the price of oil, I played with it dropping to $20, but yesterday it went below $15. The figures from Mexico, figures from the American banking industry—especially Bank of America, and the figures from the small banks in Texas and in California were frightening beyond belief at $20. Shouldn't we get into this situation before it becomes a world crisis? I am not expecting from your answer for you to identify it as a crisis, but shouldn't we look at it?

Mr. Volcker. I think you ought to look at it in the sense of does a basic favorable development contain the seeds of running to such extremes that the adverse side effects overwhelm the favorable aspects. At what point that might be the case I think is worth some thinking. It is just not necessarily the case that more reduction is always better.

Mr. McKinney. My time has expired. I have a few more questions about oil that I would like you to answer, but I will send those to you.

The Chairman. Mr. Kleczka.

Mr. Kleczka. Thank you, Mr. Chairman.

Chairman Volcker, you ticked off a lengthy list of legislative priorities which as noted has been reported by this committee. So we have met our responsibility.

Mr. Volcker. Some of it has.

Mr. Kleczka. The bulk of I think the agenda has. So if we could schedule you before the Rules Committee I think we——

The Chairman. Excuse me. The fact that the Fed said that it doesn't mean that we—you know.

Mr. Volcker. I agree, but it is an observable fact that that whole list has not been refined.

The Chairman. We will talk some more about how we can get these things accomplished.

Mr. Kleczka. Well, anyway, in the portion of your statement where you indicate time is growing short and we have to modernize our laws, you also talk about banking and thrift industries are left to drift, driven to exploit and words of that nature, which brings me to another bill reported by this committee which is termed the Cash Availability Act.

Would you, Chairman Volcker, also put that bill on your list of priorities and what is your reaction to that legislation?

Mr. Volcker. First of all, it was not on the list. I realize it is before the committee and the consideration of the Congress. I do not consider——

Mr. Kleczka. It has been reported by the committee.

The Chairman. It has passed the House.

Mr. **Volcker**. I understand it has passed the House and will be before the Senate.

The **Chairman**. You weren't too excited about it.

Mr. **Volcker**. It is not a safety and soundness issue as I view it, and I was looking at things that affect the structure and safety and soundness of the system. It is more in the area of a consumer issue and I think there are problems in this area.

The Board took the position that they would prefer to see work in this area continue on a more voluntary basis, with more enforced disclosure, but not a legislative rule defining the length of the availability period, and that is our position.

Mr. **Kleczka**. Well, that is disappointing to hear. I think the safety and soundness of our consumers is as important I think to all of us as the safety and soundness of our banks.

Mr. **Volcker**. I am not so sure. I think it is an important consumer issue. I know from personal experience.

Mr. **Kleczka**. Mr. Chairman, if left to the banks, I am sure we would be here in 1995 and still studying the situation and looking at it and possibly the float at that point might be 30 or 45 days.

Mr. **Volcker**. That is a judgment you have to make, but I think it is a question of how the consumer is being treated in this area.

Mr. **Kleczka**. Well, we sure would appreciate your support and leadership on that also.

Nevertheless, on the whole question of international debt, I think Mary Rose Oakar brought the subject forward using the Philippines, which is quite sensitive, and let's use Peru instead and cite President Garcia's statement wherein he will only repay 10 percent of its export earnings or about $340 million toward its interest payments versus a tab due of some $1.3 billion.

Mr. Chairman, are we getting to the point where we are going to be faced with an OPEC of debtor nations wherein annually they will sit down and by international cartel set what they are going to be repaying? And if in fact we are moving to that situation, what is the effect of that on American banks?

Mr. **Volcker**. I think the effect on the American banking system would not be favorable, but more broadly than that, I think it is inconsistent with any normal operation of an international or a domestic credit system, and it would imply a breakdown of the international credit system that I think would work, first of all, adversely in terms of the interests of those countries, because if they are going to grow and become more efficient, they are going to have to grow in the context of a world economy with expanding trade connections, all of which involves financial connections and credit. And if you reject the normal rules of credit, I think they are going to be in great difficulty.

Mr. **Kleczka**. With that being said, Mr. Chairman, the fact of the matter is that they are rejecting the rules of credit, and I ask you what is our recourse to nations like Peru?

Mr. **Volcker**. You say they are rejecting the rules. I would be careful about generalizing that. Peru has for the time being seemed to go off on a direction of their own, and I don't think it is doing them any good, but that is my judgment. But that has not been a general movement through Latin America or elsewhere at this point certainly.

Mr. KLECZKA. But if Peru is successful in this effort, I am sure they are going to be followed by other debtor nations.

Mr. VOLCKER. It will be interesting to see how you measure success.

Mr. KLECZKA. If they get away with it.

Mr. VOLCKER. You could get away with that in some sense. You don't pay your bills. But the larger question is whether it is successful in the growth and stability of Peru, and I think that that is a very doubtful proposition.

Mr. KLECZKA. Fine. Thank you.

The CHAIRMAN. Mr. Chairman, I have to say that when John Q and Jane Q citizen deposit a check, and they can't use that money for 14 to 16 days and they have to buy groceries and pay the rent and buy the oil even though the oil price has come down, that affects the safety and soundness of that consumer, and that is why we passed that bill by a margin of 282 to 11.

Mr. VOLCKER. I understand that there is first, a problem and second, that a lot of people are upset by it. I understand the upset and I sympathize with the upset.

The CHAIRMAN. Sympathy isn't enough, Mr. Chairman. Results are what we need.

Mr. VOLCKER. There is still the question of the effective way to go about it.

The CHAIRMAN. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

Chairman Volcker, in light of the short period of time for questions, I would like to ask you a couple of quick questions.

First, I appreciate the answer that you gave to Mr. Levin and Mr. Carper regarding certain priorities as they should stand before the committee.

The first question I would have for you is this. There seems to be significant disagreement as to whether IRA accounts, and this is IRA season and it seems like it really boosts the domestic savings rate in this country. What is your opinion on whether IRA accounts and that reform of a few years ago has really increased the domestic savings rate?

Mr. VOLCKER. I think experience suggests not much, if anything. The problem you have with this kind of selective measure, and over time it may have a bigger effect--is it induces a lot of shifting of money that otherwise would have been saved in that particular form without necessarily increasing and certainly without an equivalent increase in the total savings rate. At the margin, it should work in that direction, but it is hard to see the results from that.

Mr. COOPER. The implication of that from a policy standpoint would seem to be since it is very expensive from a tax revenue raising standpoint that it perhaps is not worthwhile to grant such a large concession if it is not increasing the domestic savings rate.

Mr. VOLCKER. I would suggest to you, on the other hand, that I think the counterpart to the relatively heavy tax on equity is that we tax savings relatively heavily in this country across the board. In fact, there is a kind of double taxation of savings. You pay income tax when you earn the money in the first place, and then, if you save it and get some interest, you pay another income tax on the interest that you have earned.

And if you want to correct this all the way—and it involves very major changes in the tax structure—you obviously go toward a consumption tax. That, I think, would have an effect on the savings rate. [Laughter.]

Mr. COOPER. That, fortunately, from my standpoint is the province of another committee of course.

The issue of overvalued dollars, you said that the dollar had fallen enough you thought. What should we tell our manufacturers who are being battered by imports when we have told them well, look, an overvalued dollar is the equivalent of a tax on what you send overseas or a subsidy on what is imported. Is it fair to say to the manufacturer in this country today that there is no implicit tax due to the overvalued dollar on what they are trying to export overseas?

Mr. VOLCKER. I know the dollar is a lot lower relative to our leading trading partners, especially Japan and the continent of Europe, than it was 6 months ago or 1 year ago, so, there has been a rather drastic change in that respect already. I don't know where the correct competitive level of the dollar is over a period of time.

But I do have the sense that in the short run, by which I mean not next month but through the year and beyond, it is at least as important and probably more important—in terms of their ability to export or to compete with imports—what kind of growth you are getting abroad relative to what kind of growth you are getting here.

That exchange rate isn't going to affect anything very drastically in the short run, and I suspect its lags are rather longer than changes in income, and I don't want to forget about that side. And because the lags are so long on the exchange rate side, it is very easy to overshoot on the down side. We have had lots of experience in that and it gives you lots of problems.

Mr. COOPER. The third question would be on the graph you included at the end of your testimony, the ratio of domestic nonfinancial sector debt to GNP.

Would it be fair to conclude from looking at that graph that just as significant as the Federal debt problem is the non-Federal problem in terms of our overall debt related to GNP?

Mr. VOLCKER. That certainly suggests that there is a change of behavior in the private sector and it is rising pretty fast. That chart I don't think adjusts for what is I think a passing amount of State and local government debt that was issued particularly rapidly last year in anticipation of tax law changes. So that trend is somewhat exaggerated for the past year for the non-Federal debt simply by the explosion in State and local government debt, but it has been trending higher and that is good.

Mr. COOPER. Is it possible to compare the harm that non-Federal debt does to our economy when it is accumulated in excess amounts as opposed to Federal debt? Are they two similar types of debt?

Mr. VOLCKER. They have got different characteristics obviously, and the non-Federal debt is no problem so long as it is matched by increasing productivity, which should be reflected in the GNP. It is not a problem unless it implies a degree of financial strain or fragility. So you look to other evidences of whether that is developing.

So far, I think that is relatively well contained, although there are some symptoms in the consumer area of rising delinquencies, for instance. They are not frighteningly high, but they have been tending upward.

For the moment, the effects of the debt on corporate balance sheets and even on consumer balance sheets is somewhat obscured by the fact the stock prices have been going up so far. So if you say you look at wealth against debt, it hasn't changed all that much in the past year.

But that leaves you with the question of how much you can rely upon constantly rising stock prices should the debt phenomenon continue.

Mr. COOPER. Thank you, Mr. Chairman. My time has expired.

The CHAIRMAN. Mr. Hiler.

Mr. HILER. Thank you, Mr. Chairman.

Chairman Volcker, capacity utilization remains at about 80 percent and maybe marginally above that.

Mr. VOLCKER. Between 80 and 81 percent, yes.

Mr. HILER. Inflation pressures remained relatively stable and relatively low compared to certainly the late seventies. Commodity prices at this particular point led by oil prices and food prices have been falling, but they have been at rather depressed levels for much of the last several years.

Gold as an indicator has fallen dramatically in the last 4 or 5 years, but it has remained relatively stable over the last 12 months.

Given the positive impact of lowering interest rates, not only in the economy, but also on the Federal deficit, I believe the figure is that it is now projected the deficit in 1991 would be about $51 billion lower due to the effect of lower interest rates.

Why wouldn't this afternoon be a good time for you to go back to your office and set up an FOMC conference call and suggest and put to a vote lowering the discount rate?

Mr. VOLCKER. Because I don't want to imply whether that is appropriate at the moment, but I will give you some other considerations that have to be taken into mind.

You recite a lot of relatively favorable and a lot of not just relatively favorable but plain outright favorable price statistics. I also note that the overall inflation rate remains at 3½ to 4 percent during this period, but the decline in the dollar itself, just looking at that factor and it is not an unimportant one, carries potential inflationary implications down the road.

The economy appears to be growing currently at a reasonable rate. M1 at least has been running quite high until very recently anyway. Those are some of the factors that we have to take into account in reaching those judgments because what we do today is going to affect things out there in the future, and we want to keep things going insofar as we can influence them in the kind of favorable direction that you describe.

Mr. HILER. I may come back to this. The second question, in your testimony I thought I heard a call for some stability in the international monetary markets and that you basically supported the

President's call for some type of international monetary conference to discuss these kinds of issues.

Implicit in your statement I believe is a certain—there would be implied a certain targeting of exchange rates either in a fixed or in a restrained floating mode. I wonder, am I reading more into your statement than I should or are you suggesting that it may be time to go back toward a fixed exchange rate system or to a restrained floating rate system?

Mr. **Volcker**. One way or the other I think it is implied. I am not necessarily implying going back to a fixed rate system by any means. But I think you raise an appropriate point. If you are going to have a system that works toward more stability in the exchange rates, you have to know what you are stabilizing. You have to have some idea as to what an appropriate exchange rate is, I agree with that. And that is one of the difficulties, I might say, in arriving at agreements on that subject.

The disagreement begins right there. People have different opinions about what an appropriate exchange rate is even if you define that rather loosely, which is certainly encompassed in what I say. You don't have to decide that—whatever today's exchange rate is, you don't have to decide that it is 250 marks to a dollar or whatever. You have to have some general idea.

You would have to have some general idea that the heights that the dollar reached in 1984 and 1985 were too high and that presumably the low points that it reached at some other time were too low. You would at least have to have that kind of an idea.

Mr. **Hiler**. Getting back to the discount rate question, I think the FOMC has, you know, the median, their central tendency on inflation for the next year is about 3½ percent I believe is the figure.

Mr. **Volcker**. I think if you average, just straight average, it would be something like 3½ percent. The central tendency was rather wide, but the average is 3½ percent as I recall it, yes.

Mr. **Hiler**. Given that, and that is in spite of the fact that the value of the dollar has declined by nearly 30 percent over the last year, I guess it would seem to me that possibly a little experimenting with the discount rate this time might be called for.

Mr. **Volcker**. I point out just technically you are quite right, despite the decline in the dollar, because I think many of the members were thinking that during this time period that would be offset by the decline in oil. So you have, in some sense, a fortunate juxtaposition that the inflationary effects of the depreciation in the short run may be largely offset by the change in oil prices, but 3½ percent strikes me as hardly satisfactory for a target over a period of time. But you have expressed a position on the subject, and I understand that.

Mr. **Hiler**. I thank the Chairman. My time has expired.

The **Chairman**. Mr. Morrison.

Mr. **Morrison**. Thank you, Mr. Chairman.

Mr. Chairman, it is a pleasure to have the opportunity to question you today and I thank you for coming before the committee.

A little earlier there was some discussion of the agricultural banking area and the vulnerability of those institutions. There also has been some mention of Third World debt and domestic energy loans as areas of vulnerability in a change from an inflationary world to a less inflationary and in some cases disinflationary or even deflationary situation.

What have we learned about banking regulation from that experience? You answered the concern about the farming community and the banks saying it wasn't really their fault, the farmers, that they got themselves caught in this credit squeeze having run up their debt when their land values were going up and now they caught in the squeeze on the way down.

Whose fault was it, and to what extent was it the bank regulators for believing that this inflation was forever and people could premise their credit decisions in that way?

Mr. VOLCKER. I would say in the most general terms a large part of the fault is national policies that permitted the inflation to arise to the extent that it did in the first place and to persist as long as it did in the first place. And I think that is fundamental, so I have to mention that.

As far as the more limited field of banking regulation or supervision is concerned, I think you are obviously dealing with human psychology that affects not just banking. It does even affect banking regulators and supervisors and it obviously affects bankers and others when things have gone well for a long time.

The mere fact that they have gone well for a long time and you haven't had any problems induces reaching toward the outer limits of lending or other forms of human activity. The job of regulators and supervisors is to create some drag on that process, because it is their job to try to look ahead and foresee problems. But that is very difficult to do in an atmosphere where nobody else is looking at things that way.

Banking regulators and supervisors, I suppose, are never very popular, but they are particularly unpopular when there are no evident problems and they are trying to exert a restraining influence. I think they do that, but you can ask whether they did it to a sufficient degree. Did the Congress give them the tools and the support that was necessary in that kind of a period?

Mr. MORRISON. Well, I guess the part of your answer that disturbs me is saying when things were going well. The inflationary situation was in some narrow sense things going well, but it seems to me the general verdict even at the time was that inflation wasn't really a positive influence on the economy, and it was that inflation underlies a lot of the credit problems now.

Mr. VOLCKER. Sure.

Mr. MORRISON. So it isn't just going well. It seems to me that we can't just criticize this after the fact unless we are going to have a boom and bust kind of situation permanently.

Mr. VOLCKER. I agree, so we have got to work to fight that human tendency to relax the guard too much when things are going well. I think an inverse of that is you don't want to be too tough when things are going badly. You don't want to over-react, and this farm problem is a perfect example of that.

I don't think it is correct for the banking supervisors and regulators to march through the farm communities these days telling those banks to write off anything upon which there is a possible question, which is another human tendency that could arise during this kind of situation.

We have got the tough job of trying to maintain the appropriate balance in both cases when people are feeling a little exhilarated and exuberant and when they are feeling a little depressed and try in our operations to work toward some kind of balance.

That is a very vague answer, but I think that is the heart of it.

Mr. MORRISON. Would any of the legislation on your laundry list provide tools for the future so as to restrain the overenthusiastic extension of credit against inflated values?

Mr. VOLCKER. Yes, there is no question. For instance, very explicitly on my laundry list is the question of either Congress doing it or providing authority to those of us who are involved in Federal banking regulation to put some limits on the activities of the institutions that we supervise that may be permitted by State law, but in our judgment exceed reasonable bounds of financial prudence.

I think that is an area that is aching for some response now, because it is under particular pressures in many States, particularly in the thrift industry, but, the banking industry is not exempt. There are powers being provided and used that I think go beyond a reasonable interpretation of what the Federal Government should be insuring.

Mr. MORRISON. But you would agree that the federally regulated and federally chartered commercial banking industry also has had some of these same over-extension problems, wouldn't you?

Mr. VOLCKER. Yes. It is not just a question of powers. You have got to look into particular loans. An energy loan; there is no more classic kind of bank lending than for energy, to energy companies and energy development companies or for construction. But then you get into the question of on what terms and conditions that is being done. That is a matter of supervision. You can't control that by law. That is a question of getting in there and getting your hands dirty with a little supervision.

Mr. MORRISON. My time has expired, Mr. Chairman.

The CHAIRMAN. Mr. LaFalce.

Mr. LAFALCE. Thank you, Mr. Chairman.

Chairman Volcker, it is always a pleasure to have you before our committee.

I have three questions.

The first I would ask you to respond to in writing rather than at the present time.

I was one of the 12 Members of the House of Representatives that challenged the constitutionality of Gramm-Rudman on the theory of excessive delegation of congressional powers and also on the theory that the separation of powers clause had been violated.

At the very least, the lower Federal Court agreed with us on the latter argument primarily using as their gravamen the fact that the Comptroller General's office is more legislative in nature than executive in nature, and that therefore the legislative branch had retained powers that should have been within the hands of the executive branch, thereby violating the separation of powers clause.

I am interested in the Federal Reserve's opinion as to its own status. Is it more executive or more legislative, is it independent or is it a combination of all three at different times for different purposes? And then under what circumstances or what conditions would those questions be relevant, and what would be the ramifications depending upon the outcome of the answers to the questions that I have raised?

Mind you, a case of beer depends on the answer you give me to that question. [Laughter.]

Mr. VOLCKER. You might give me a hint as to what direction. [Laughter.]

Mr. LAFALCE. I haven't even told you my initial inclinations and that is why I asked for your opinion in writing. I am sure your legal counsel has been worried about this.

Mr. VOLCKER. I think I will have to resort to advice of counsel and we will give you a written answer. [Laughter.]

Mr. LAFALCE. And seriously, I think that that is an important question that the Federal Reserve and all of the so-called independent agencies will have to be dealing with in the future. That is one of the reasons that I would like, if not an opinion, a memo from your office discussing that issue.

Mr. VOLCKER. I understand.

Mr. LAFALCE. My next two questions I will pose at the same time and then I will ask you to answer them.

As you know, I introduced what is known as the Competitive Exchange Rate Act, and I presented it as an alternative to two different approaches that have been advanced, one, a return to fixed rate systems, and the other a mechanistic approach to intervention in the markets. You and I had some discussions regarding my bill and I modified my bill in an attempt to win your favor, the favor of the Treasury and the bipartisan favor in the Congress eliminating the Commission, et cetera.

I would ask you to consider the latest version of the bill which has been reported out of the Banking Committee and then discuss it with me at some time in the future.

But most importantly, don't you think it, if not imperative, at least quite important that periodically, at least with the same regularity that you must report to us under Humphrey-Hawkins, that the Federal Reserve and the Treasury ought to report to us on the implications of exchange rates. Shouldn't we regularize such reporting, whether informally through the hearing process or statutorily by mandating that you appear periodically?

Mr. VOLCKER. I don't have any objection to that, and I think it could be useful.

As you may recall from our earlier discussion, I have a certain antipathy toward legislating some requirements that seem important and valuable at a particular point in time to very quickly become a routine that nobody reads and nobody spends much time on. It takes a lot of time to prepare them, but it may not receive top-level, continuing attention when it becomes a routine report that the subject matter may not deserve.

As you stated, I have no problem at all, but I would hope that it could be incorporated in reports such as the one I delivered today rather than a separate kind of pro forma operation. We have too many of those already, particularly in these days when we are trying to reduce spending.

Mr. LaFalce. The subject of exchange rates is so arcane to most, unlike inflation and unlike unemployment, that sometimes we need a full discussion of it. For example, I would like you to give me a full discussion, not now, but in writing as to how far is too far for the dollar to drop and how fast would be too fast?

What formula does the Fed have or is it working on to help develop what appropriate exchange rate zones might be, if not the specific amount?

And another thing. As a border Congressman I am interested in the trade deficit we have with Canada which per capita far exceeds the trade deficit we have, for example, with Japan, and the fact that our dollar has risen with respect to the Canadian dollar. I would like your explanation as to why that is the case when the dollar has dropped against the yen from 260 to 180 or so.

Do I have time for one last question on Third World debt with the permission of the committee?

The Chairman. Mr. Wortley.

Mr. Wortley. Thank you, Mr. Chairman.

Chairman Volcker, it is always a pleasure to listen to your keen insights into the economy.

The current tax bill, the one that was passed by the House and is now pending over in the Senate, shifts the tax burden substantially from the individual to corporate America, the extension of the depreciation schedules, the elimination of the investment tax credits and raising the capital gains tax.

If the bill that came out of the House is adopted over in the Senate or at least those portions shifting the tax burden to corporate America, what affect might that have upon your monetary policy?

Mr. Volcker. I just am not competent to get into a discussion of how the particular shape of the tax bill may affect the world and therefore monetary policy. I simply have not studied it in enough detail——

Mr. Wortley. You must be giving some serious thought to it though.

Mr. Volcker. I think my answer reflects the fact that the particular aspect that you raise, which I recognize is an important aspect, has not loomed at this point as decisive in terms of monetary policy or I would have given it more thought. That has got a long congressional process to go through yet in the Senate, and there may be substantial changes. But I don't think those effects even as they stand would be as large, for instance, as the fiscal effects of the Gramm-Rudman type of legislation. That has rather obvious implications on the overall budgetary posture, the financial markets and the economy of a sort that are more urgently relevant to us, than the shape of the tax reform program. So I am just not equipped to—I am afraid to answer your question.

Mr. Wortley. I hope this is not a subtle way of telling us that the decisions in that area will not have to be made on your watch.

Mr. Volcker. No. I guess it is not such a subtle way of telling you I don't think the prime implications of that bill are for monetary policy.

Mr. **Wortley**. I wonder if I might tie into the the pursuit of my esteemed colleague from New York, Mr. LaFalce, when he talked about the value of the dollar and its decline.

It has been, since the middle of March of last year when the dollar started downward, just about the time of the Ohio bank holiday. In the last few days the dollar has dropped very sharply against the Japanese yen.

In your opinion, do you think the dollar is falling too fast now or are you satisfied with it?

Mr. **Volcker**. No, it gives me some concern because I don't want to see a loss of the basic underlying confidence in the dollar. As I said, I don't know just where the dollar should lodge, but I know that just because some adjustment was necessary, it doesn't mean that every adjustment is desirable no matter how far it goes.

I think the more critical factor in our trade position right now, as I have said on a number of occasions and this morning, is the problem of balanced growth in other countries as well as in the United States. In some ways an exchange rate change that is too sharp works against that in the short run.

Mr. **Wortley**. Of course it will improve our balance-of-payments situation.

Mr. **Volcker**. It will improve the balance-of-payments situation over a period of time, and that will be quite a long period of time if we don't feed it back into domestic inflation. But I would repeat a point I made in my statement. There has been lots of experience around the world and, unfortunately, lots of experience in the United States of rapid depreciations of the currency feeding back and aggravating inflationary problems that made economic performance worse, not better.

Mr. **Wortley**. Do you have a target of your own as to how far the dollar might fall?

Mr. **Volcker**. I do not, not at this stage.

Mr. **Wortley**. I am getting the message that my time has expired.

Thank you very much, Chairman Volcker.

The **Chairman**. Mr. Morrison.

Mr. **Morrison**. Thank you, Mr. Chairman.

I would just like to follow up a little bit more on this currency adjustment. I understood you to say during the course of your testimony two things. One, that you thought that the value of the dollar had fallen far enough for the moment at least as to satisfy the biggest part of the over-valuation problem, and that the more important trade issue was the need to promote growth elsewhere to create broader markets both for the goods we might otherwise import or for goods we might export.

But is your statement that you think the equilibrium position we are at now is an appropriate long-run policy or just that the priority between those two concerns, the currency concern and the market concern has shifted?

Mr. **Volcker**. I think it is the priority concern. I don't know what the precise equilibrium value of the dollar should be over a period of time. That is going to depend upon our inflation rate and it is going to depend upon those growth rates and it is going to depend upon quite a few things.

I do think it is crucially important, particularly when we have to borrow $150 billion a year that we have some willing lenders.

Mr. MORRISON. The statement about confidence in the currency and strength of the currency, does that reflect a general notion that the currency should be in some sense overvalued or more attractive than other currencies in the world?

Mr. VOLCKER. I don't want to make it overvalued. What I want to make it is, I guess, properly valued, and nobody knows that precise answer at this time. But you don't want a situation in which people are running out of the currency.

Mr. MORRISON. I have no further questions, Mr. Chairman.

The CHAIRMAN. Mr. LaFalce.

Mr. LAFALCE. Thank you.

Chairman Volcker, I have asked you a question based upon a lawsuit I brought regarding Gramm-Rudman and based upon the Competitive Exchange Rate Act that I introduced in the Banking Committee as reported out.

Now I would like to ask you a question based upon an experience I had in January. I became much more involved in the whole issue of Third World debt when I led 12 Members of the Banking Committee on a trip to, amongst other countries, Peru, Argentina, Brazil, and Venezuela, I became much more concerned about what might be the next crisis of Third World debt.

Our interest rates have come down somewhat, and that has to help alleviate the Third World debt pressures. Oil prices have come down considerably, and for some Third World debtors that is excellent. For Third World debtor oil producers that presents grave problems.

The dollar has come down considerably against a basket of currencies and against most currencies. That is very good for some and not good for others.

Given these changes that have taken place, given the difficulties that countries are having achieving economic growth in order to service their debt, given the fact that we have very few moneys remaining within our multilateral financial institutions, given the short-term nature of IMF assistance and the need on the part of these countries for long-term assistance in order to achieve economic growth, what do you foresee insofar as the next Third World debt crisis? When will it be upon us, will it be upon us and to what extent will it be upon us? Will it rival in magnitude the crises we experienced in 1982?

Does the Baker initiative, and I don't say the Baker plan because it can hardly be called a plan, the Baker speech he gave in Seoul, Korea, does that go far enough in helping to put a lid on the possible explosion? Have there been sufficient steps taken since the September speech in Seoul, Korea, to follow up on that initiative? We know of the meeting that they had in Montevideo, et cetera, when they said OK, as a first step, and they brought in the Foreign Ministers and the Economic Ministers of the Latin American countries. But, it doesn't go nearly far enough.

Please share with me your thoughts on this very important question.

Mr. VOLCKER. Let me share a few. You ask, obviously, a very broad question. I want to correct one assumption you made. I think

I generally accept the others. You said the international multilateral institutions didn't have much money. They have got enough money to do their part in dealing with the situation for the next 2 or 3 years. At that point their resources may become strained, but I don't want to leave any doubt that there is no problem as I see it, in the immediate future, with the amount of money that those institutions have available to do their part in this situation.

Mr. LAFALCE. Assuming the implementation of the Baker initiative?

Mr. VOLCKER. Yes. For the next couple of years, yes.

Now if everything goes successfully, at that point they are going to be out and they would need a replenishment. But right now I don't think there is any question for the World Bank in particular.

As far as the implications of this situation are concerned and its relative nature and intensity compared to what happened in 1982, let me point out one thing that I don't think is widely realized. I don't have the figure precisely in mind, but there has been a substantial reduction in the exposure of our banks relative to capital or relative to their assets—it is usually measured relative to capital—of their lending to, let's say, the 15 countries that were specifically identified as part of the Baker initiative. It has come down more than——

Mr. LAFALCE. I don't mean to interrupt you for too long, but don't consider just our own financial institutions. We have to consider also, for example, the socioeconomic political stability of these newly emerging democracies.

Mr. VOLCKER. I fully agree with you, and I am only beginning with one limited aspect of it. I simply want to point out that the vulnerability in that sense in relative terms is 25 to 35 percent less. There is less exposure to those countries in relative terms than there was in 1977. It is still very large. I don't want to minimize it in any sense, but it is one aspect of the situation.

Now you obviously point out the implications for those countries for our economy, and one of those countries is right on our border, obviously, and what happens there has enormous implications for American society as well as for Mexican society.

The general answer I think I must give you is that what happened for those countries that are oil producers—and obviously it helps the ones that are oil consumers as you said—is it makes more intense the need for them to consider the kind of policies at home that have real promise of speeding growth and maintaining confidence in their economies and currencies.

In that sense it seems to me the Baker initiative, which was very broadly put—and it had to be broadly put because circumstances in every one of these countries differ—had an emphasis that is certainly right and equally applicable today. It is only that the intensity or the need has increased in some of these countries, and that emphasis is on self-help and what can they do themselves to improve the competitiveness and efficiency of their economy, and I think we all sense that there are things that they can do.

I think within those countries they have been talking about doing those kinds of things and you have seen steps taken; for instance, quite dramatic steps in Argentina recently, and you have seen some steps in Mexico. Now it is very hard to take those steps.

They have got a lot of political opposition, too, but the need seems even more pressing.

They are not going to do it, in my judgment, purely on their own. You cannot say, "You go take those steps, you sink or swim on your own." To make those steps reasonable from their standpoint, they also have to have a view of the world that says if we do them, we are going to have markets for those new exports and those new oil exports. That is absolutely crucial and that depends upon what we do.

They are also going to need some financing and they have got to be able to look toward the reasonable availability of that financing if they do the job at home. And basically when I say that I am describing the guts of the Baker initiative.

Now as to whether the precise numbers for each country apply, precise numbers were never developed. We had some numbers in the background, but how much Mexico might need and how much Brazil might need and how much Argentina might need, whatever those estimates were—presumably Brazil needs less and Mexico may need more—whether the overall total is wrong, one can look at. You don't have to write that in absolute stone, but I don't think that is the problem; the problem is the policy issues.

Mr. LAFALCE. We have got an awful lot of newspaper headlines and talk, but aren't we approaching the point where we had better get some action with respect to this and pretty soon.

Mr. VOLCKER. Yes.

Mr. LAFALCE. How much time do we have?

Mr. VOLCKER. Not much.

Mr. LAFALCE. How much?

Mr. VOLCKER. I don't think that means the time has been wasted. The action depends upon a coordinated effort by the countries and others. You can't act before the countries act, and now they have been faced literally, in a matter of weeks, with a quite different—and from their viewpoint, obviously and from our viewpoint—in some respects a very disturbing and profound change in the oil price, but that has been going on, for what, 4 weeks. You are not going to expect magic and a fully developed program 4 weeks after you know that you have got to change the circumstances.

In Mexico, I have the impression they were well along in developing a program for 1986 before this hit. Argentina certainly was. Now Argentina isn't much affected on balance by the oil situation, but Mexico surely is. And there isn't much time, I agree with that, but there has got to be more than 4 weeks. It has got to be done right, and this has been a very uncertain situation, and they are in the process I am sure of deciding how to respond to this question. They are certainly a potentially strong country in areas other than oil.

In the long run, oil need not be all that dominant in their economy or in their exports, and they are going to have to debate what to do and decide what to do and I hope they take enough time to do it right.

The CHAIRMAN. Mr. Wylie.

Mr. WYLIE. Thank you, Mr. Chairman.

Chairman Volcker, I want to go to another subject where you say time is growing short. You stressed in your testimony the need to preserve the safety and soundness of our financial system. Particularly on pages 24 and 25 you encourage Congress to act and act soon to modernize our basic financial laws, and you conclude by stating that a lack of congressional guidance is a clear threat not only to coherence, but also to the safety and soundness of the whole. Time is growing short is the way you ended up.

I understand that Congressman Carper got into this subject a little bit, and I am sorry I wasn't here to hear what you said to him. But I am very apprehensive about the rapid expansion of the delivery of financial services and I have three questions that I will lump into one.

Should we act quickly on H.R. 20, the nonbank bank bill in its present form? Should we add amendments to H.R. 20? Or should we for a variety of reasons confess that Congress has not acted and therefore we have reached the point of no return and that maybe the genie is out of the bottle and that what we really should do is to regulate these diversified financial intermediaries and say that they are here to stay and that we need to bring them under the Bank Holding Company Act so that they can be examined as to safety and soundness?

Give me a little advice, if you please.

Mr. VOLCKER. I am inclined to answer yes, yes, yes, but I had better explain that a little bit.

Mr. WYLIE. All right.

Mr. VOLCKER. You have got a question about substance and obviously legislative tactics and just how you approach it.

Mr. WYLIE. Right.

Mr. VOLCKER. I certainly see something like H.R. 20 as the core of a coherent effort, and therefore I would obviously like to see that passed. You ask should it be expanded? That is purely a question of legislative tactics. I think there are other issues that get involved here that I would like to see the Congress and this committee considered that I consider very much complementary to that effort, but that doesn't mean it has to be done in the same bill.

That bill certainly lays down a philosophical guideline in an area that is crucial to the rest, and then if you don't pass it, the only relevant question will be your third.

I don't quite see how precisely one would go about regulating all these other conglomerates. You know you ask a very strange question, the great concern expressed by some about any enlargement of powers of bank holding companies, and then on the other hand, you say, "Well, let anybody go in the business." I mean one or the other of those positions may be right, but they both can't be right.

Mr. WYLIE. That is right, and what I am asking you is to kind of pick and choose. Should we go in the other direction and say that we want to give you some congressional guidance in the area of transactions among depository institutions and restrictions on the type of services that they perform? Should they be examined as to safety and soundness, the Ohio situation that was brought up here a little earlier, and I remember the case——

Mr. VOLCKER. I don't want to examine Sears & Roebuck.

Mr. WYLIE. You don't?

Mr. VOLCKER. No. They are a big——

Mr. WYLIE. Too, big?

Mr. VOLCKER. They used to think of themselves as a big and grand and proud retailer. That is not our business. It is a question of what their business is I guess at the margin.

When you are getting into questions of the payment system and access to it, I think the philosophy in the country has been, and I think it is a wise philosophy, to limit that to banks and certain regulated depository institutions. That is what I think the thrust of H.R. 20 is and that is why I support that.

We had a situation, as you know, that arose out of a computer failure recently. It may be a small example in one way, but quantitatively it wasn't so small. Because of one participant in the payment system having a computer breakdown, we ended up lending them, whatever it was, about $23 billion over night. We knew that institution and we had collateral in-house to back that lending. There was not any appreciable risk in that loan so far as we can see.

You get somebody else operating in the payment system, and I don't know what you would do in a similar situation. That is one little kind of technical aspect of this whole thing.

Mr. WYLIE. I will use that as an argument as to why a safety and soundness would have been good on the funds availability bill, but it didn't get me very far.

Mr. VOLCKER. I agree with the point you made.

Mr. WYLIE. Well maybe we need to revisit the scene in H.R. 20. Does H.R. 20 meet the safety and soundness test that you would like to see?

Mr. VOLCKER. There are many other things involved in safety and soundness. I think what it does is lay down the basic guideline that would be followed in making a distinction between banking institutions, banking like institutions and their regulation and nonbanking institutions, and that is what we are lacking now, a clear borderline between the two.

Mr. WYLIE. I think you have gone about as far as you can in answering it and you have been helpful. Thank you very much.

The CHAIRMAN. Mr. Chairman, I think what you mean is that although H.R. 20 does indeed address many of the existing safety and soundness problems there are other steps that should be taken as well.

Mr. VOLCKER. It is certainly relevant to the issue because it lays down the basis for pursuing the safety and soundness issue.

The CHAIRMAN. Well, the reason I mention this, Chairman Volcker, is that we all have what we think are our expertises, including you and I in some ways. Don't get me wrong, I am not trying to draw a total parallel. After all you are the second most powerful man in the country——

[Laughter.]

Now I am being complimentary.

Mr. VOLCKER. My feelings in that matter are quite in contrast to others I take it, but be that as it may.

The CHAIRMAN. Anyway, the fact remains that both you and I have been characterized as playing it close to the belt and keeping our own counsel. But let me just unkeep some counsel here, and that is that when you are dealing with monetary policy, you are the expert; however, we try to be experts at legislative policy.

I just say to you that one of the problems I am having with H.R. 20, as it now stands, is that there are those whose ox is being gored because of a few sections in H.R. 20 and therefore they are resisting having that legislation reported out of the Rules Committee.

Now my contention is to let it out of the Rules Committee. Let's go to the floor where 432 Members will have an opportunity to make up their minds on some of the controversial sections that I know you support. As you know full well, there are those from States like California and Texas who are upset with them too.

Mr. VOLCKER. And Florida.

The CHAIRMAN. Well, Florida is not that upset any more.

Now let me say this to you. I want you to take advantage of the sobriquet that has been given to you in this national publication that came out yesterday that we all read like the Bible—[Laughter]—and I want you to speak to the Rules Committee of the House and say this is the second most powerful man in the country speaking—[Laughter]—and I in the Federal Reserve want H.R. 20 reported out of rules so it can be addressed on the floor of the House.

Mr. VOLCKER. I have great deference to your legislative skills, Mr. Chairman, but I don't think I will start the letter that way. [Laughter.]

The CHAIRMAN. Well, imply it I would say, or maybe you can just send them a copy of the article. [Laughter.]

Very seriously, that would be very helpful.

Now you have other items on your list of priorities, and let's you and I chat for a moment here as we conclude this most interesting hearing. Really it has been fabulous and I think that you, too, probably appreciated the participation of the Members.

Mr. VOLCKER. I do, indeed, Mr. Chairman.

The CHAIRMAN. It has been excellent and it shows the very deep interest by the membership of this committee and of that I am very proud. I am sure you are as well.

You have your list, and when you read off your list, as Mr. Kleczka brought out, you somehow or other forgot to mention delayed funds availability. Well, that also means taking in money and being allowed to use the money that is yours.

You talked about paying interest on your earnings and then about putting it in the bank and then paying taxes on your earnings and then putting money in there to earn interest and have to be taxed on that. Well, jeepers, creepers, how about putting your money in and not only paying taxes on the interest, but not being able to use your money because the bank wants to use it for free for a while.

Now if you could see your way clear to use a little power over on the Senate side now on delayed funds availability, then you and I could have a little meeting, as we have had in the past, and discuss some of the other legislation you are interested in.

As the fellow says, a little quid pro quo. You have studied this since 1978, the House spoke loud and clear on it and the consumers are aching. They are dying for that legislation. Give us a helping hand.

Mr. VOLCKER. I want to reassure you a little bit, Mr. Chairman. It was on my list. I didn't get down to it. [Laughter.]

The CHAIRMAN. That is good to hear.

Mr. Chairman, again we thank you very profoundly. A few of the Members couldn't be here and they asked me to state that they would like to send you a few questions to be answered in writing and, without objection, that is agreed to.

Again, thank you.

Mr. VOLCKER. Thank you.

The CHAIRMAN. The committee stands adjourned.

[Whereupon, at 1:13 p.m., the committee adjourned, subject to the call of the Chair.]

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